INTERNAL CONTROLS SYSTEMS, SMES AND ECONOMY OF DEVELOPING COUNTRIES: CASE OF SOUTH AFRICA

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Abstract

The significant impact of SMEs in economic growth cannot be disregarded in both developed and developing countries. Developing countries such as South Africa are still facing a high rate of unemployment and SMEs create much-needed jobs for semi-skilled and unskilled labour. SMEs are still struggling to survive, as the studies show a high rate of SMEs failure. Ineffective internal controls are among some of the reason why SMEs still struggle to survive. Internal control systems are necessary to any organisation, as they are known for their impact on risk mitigation and prevention. The absence of effective and efficient internal controls makes it difficult to manage organisational performance and the mitigate risk that threatens the ability to achieve specific performance objectives. Although SMEs are known for their benefits to the financial stability of the country, SMEs managers and leaders in developing countries are perceived to lack knowledge of internal controls. This paper will attempt to bring a broader understanding and awareness of the relationship between SMEs and internal controls on the economy of the country. Furthermore, this paper gives solutions and recommendations for the problem of internal control of the SMEs and ultimately help improve the economics of South African development. This study used secondary data, which is literature from previous peer-reviewed research papers and academic books. The study has shown that SMEs using proper internal controls influences SMEs survival, which positively influences the economy of South Africa through risk mitigation and risk prevention. The concern is the perception of SMEs leaders that the quality of internal controls can only be implemented by larger businesses.

SMEs can also implement quality internal control systems such as larger business do and improve their performance.

Keywords: Economic Development, Internal Controls, SMEs, South Africa.

1. Introduction

Small and Medium Enterprises contributes to the South African economy and other countries. The Small and Medium Enterprise (SMEs) sector promises significant benefits to the South African economy. South Africa is struggling economically due to the high rate of unemployment estimated at 24% (Garwe and Olawele, 2010:729). Akugri, Bagah and Wulifan (2015:262) mentioned that in Africa, the SMEs sector has power and influence, and account for almost 90% of all rural and urban areas.

Morongwa (2014:1) stated that SMEs are crucial to the South African economy, as they are creating more jobs. Consequently, SMEs help to reduce levels of inequality between the rich and the poor in both urban and rural areas (World Bank 2013:1). According to a study by the National Small Business Chamber (2016), SMEs in countries such as South Africa are still the key to job creation and economic growth.

Several research studies have been conducted to understand why SMEs die despite receiving some support through small business support programmes in the country. Njaramba and Ngugi (2014:44) mentioned that management skills are the key factor in the growth of SMEs, without which many SMEs fail. In support of this idea, Burger (2016:1) stated, the lack of management skills of the owner towards internal controls systems implementation has affected the growth of the small businesses. According to Jiang and Li (2010:214), many SMEs fail because they are suffering from internal operational problems, especially in finance and in the implementation of ineffective internal controls to mitigate risk.

Kakuru (2015:1) mentioned that SMEs must implement effective internal controls systems as they play a significant role in detecting and preventing risks. According to Samadi (2016:1), effective internal controls systems are necessary for large businesses and SMEs with limited resources who do not see a need to implement effective internal controls systems, resulting in risk exposure. Furthermore, Wulifon et al. (2015:265) confirm that SMEs are struggling in Africa due to the small local market, undeveloped regions integration, and difficult business conditions that comprise of complicated procedures, poor infrastructure, and inadequate financial systems.

Jackson and Stent (2007:5) mentioned that the cost-benefit approach limits internal controls. This means that the manager and owners of the business try to compare the cost of implementing internal controls and the benefits of having the internal controls. That usually leads to the ineffective implementation of internal controls systems or poor internal controls systems being put in place. Consequently, business entities become more exposed to risks or irregularity.

2. Research problem

SMEs are known for their significant contribution to economic growth and job creation worldwide. SMEs leaders are perceived to lack managerial and operational skills such as internal controls systems that lead to a high rate of SMEs failure in developing countries such as South Africa. Owners and managers of SMEs' lack of knowledge of internal controls systems could lead to the ultimate failure of SMEs, negatively affecting the economy. The benefits of SMEs are crucial for the economy of the country. The research problem statement to be investigated within the scope of this paper, therefore, reads as follows: "SMEs leaders' lack knowledge on internal controls systems and their impact resulting in poor performance, failure of the SMEs, and impact on the economic growth of the country".

3. Main research question

How does the implementation of quality internal controls systems within SMEs and leaders of SMEs' adequate knowledge of internal controls contribute to the survival of SMEs and the economy of developing countries?

4. Main objective of the study

The main objective of the study is to bring a broader understanding of the effect of the implementation of quality internal controls systems towards SMEs' survival and positive impact on the economy of South Africa.

5. Literature review

5.1 Contribution of SMEs in the economy of the country

The definition of SMEs is still unclear, as different authors have tried to give different definitions. Abor and Quartey (2010:219) mentioned that some researchers had tried to define

SMEs by various sizes, some by legal status, type of production, capital assets, the skill of labour, and revenue. The importance of SMEs in economic growth could not be overlooked, as they are the key driver of the economy compared to bigger companies.

Wulifon et al. (2015:262) stated that development is necessary and has to do with improvement in human well-being, the elimination of hunger and poverty, and the creation of employment for all citizens. Abor and Quartey (2010:223) wrote that SMEs are necessary for achieving economic growth objectives in developing countries. The World Bank (2013:1) supports that SMEs greatly influences economic growth, especially in developing countries. The advantage of SMEs is that they are flexible to market conditions compared to big companies (Abor & Quartey, 2010:223).

SMEs contribute more than big companies contribute and promise a bright future for the country's economy (Doveston, 2011:1). SMEs contribute 50% to the GDP and 60% towards job creation (Thulo, 2015:1). Furthermore, Abor and Quartey (2010:1) emphasised that SMEs alleviate poverty, as they create jobs and boost the economy. Garwe and Olawele (2010:729) mentioned that SMEs are the source of innovation, as new SMEs bring new products, advanced technology, and new competitive pressure. Furthermore, Hatten (2014:12) argued that SMEs are significant to larger businesses, as SMEs are usually better at distribution. Hutton outlines the following benefits of SMEs:

- **Flexibility**

Larger businesses are often on the lookout of ways to minimise resources to produce larger quantities of products over an extended period. Due to this obligation of trying to minimise resources, it often prevents them from reacting to new and quick-changing markets as compared to small businesses.

- **Innovation**

SMEs are known for introducing technology, developing new products, and nurturing innovative ideas with which larger businesses would compete, and that would require larger businesses to change.

- **Close relationship with the customer**

SMEs are well known for the close relationship they develop with their customers, and it enables them to have a better understanding of their customers and neighbourhood needs and wants. This understanding leads SMEs to have a competitive advantage located in special products, personal service, and quality, which benefits them when competing with larger businesses at lower price obtained by mass production.

5.3 SMEs and internal controls

5.3.1 Define internal controls

COSO (2013) defined internal controls as procedures established by leaders of an organisation with the primary objective to give a fair assurance on the achievement of three goals. These goals are the safeguard of assets, compliance with the law and regulations, and the completeness and accuracy of financial records. Whittington and Panny (2012:278-279) mentioned that in larger businesses, effective internal controls are achieved by the expansive segregation of duties. In small business, it is a concern because of fewer employees, resulting in the internal controls likely to be weak or not implemented at all.

As mentioned by Cika (2018:53), designing internal controls systems is determined by some of the followings factors: the size of the organisation, the level of the accounting department, cost, and benefits. Everyone in an organisation has responsibilities regarding internal controls such as management, the board of directors, internal auditor, external auditor, and other personnel (Hayes, Dassen, Schilder & Wallage, 2005:232). Furthermore, Whittington and Panny (2012:279) emphasised the following basic controls for small businesses:

- Reconcile all cash receipts immediately
- Deposit all cash receipts daily
- Make all payments by serial numbered checks, except all disbursements from petty cash
- Reconcile bank account monthly and keep copies of reconciliation in the file
- Use serial number sale invoices, purchase orders, and receiving reports
- Issue check to the vender of only approved invoices that have been matched with the purchase order and receiving reports
- Balance subsidiary ledger with control account at regular intervals and prepare and mail customer’s statement monthly
- Prepare comparative financial statements matching sufficient detail to disclose significant variations in any category at revenue or expense. Adherence to this basic

controls will mitigate and prevent risk from going undetected, the owner is also daily responsible to: (1) reading daily cash register totals, (2) reconciling the bank account monthly, (3) signing all checks and cancelling the supporting documents, (4) approving all general ledger entries, and (5) critically review comparative monthly statements of revenue and expense.

Louwers, Ramssay, Sinason and Strawser (2006:152) agreed that SMEs might design and implement internal controls but not the same way as larger entities do. Akugri et al. (2010:262) agreed that occasional training for SMEs should be implemented for basic records keeping and management skills. Small entities are unlikely to have a documented code of conduct, external directors, and formal policy manuals, adequate personnel to provide adequate segregation of duties or internal auditors. They, nevertheless, can reduce the mentioned conditions by promoting a culture that promotes integrity, ethical values, and competence (Boynton & Johnson, 2006:416).

Furthermore, Harrer (2008:65-66) mentioned that COSO explains internal controls to consist of five components related to all entities. Larger and small entities might implement them differently, but both still have high-quality internal controls. Jackson and Stent (2014:5) discussed the components of internal controls in the small entities as follows:

- **Controlled environment**

In the small entities, controlled activity depends on the tone set by management, as management works closely with the lower-level employees. The employees spend much time working close to the employers and have a better chance to be influenced by management behaviour or how the managers conduct themselves. The advantage of that is if the manager wants to be a good influence, he or she has a better chance to do that effectively. Due to the fewer employees, employees are more likely to do activities for which they do not have the necessary skill and knowledge. The absent of management overseeing could lead to a weak controlled environment.

- **Risk assessment process**

In small entities, it is unlikely to have risk committees, risk officers or formal risk assessment, as the business will not have the required resources for that. The assessment of risk in small businesses is usually an informal process carried out by the manager and others as they carry out their daily activities.

- **The information system**

Regarding the information system, the small business usually has a simple accounting system under the charge of an accountant and fewer assistants who usually run the entity system, which produces a basic financial information system. Although the financial information might be poor, it is likely to have fewer control activities in place to mitigate the risk of, for example, unauthorised transactions.

- **Controlled activities**

Controlled activities could be expensive to implement in the small entities, as they will not have the necessary resources to put in place such as costing security controls and hiring an additional person to improve the segregation of duties. Small entities usually have fewer transactions compared to larger entities. In small entities, some employees might carry activities for more than one cycle, not achieving the segregation of duties.

- **Monitoring**

The small entities will let the manager monitor the process of internal controls, as it is unlikely to have an internal audit department. The directors are more likely to be involved in the daily activities of the business, which could lead to little independent monitoring of fact, figures, and performance. Furthermore, Jackson and Stent (2014:5) emphasised that there are many small entities with effective internal controls, as good internal controls are designed, competent and have dedicated employees combined with ethical and "hand-on" management. It, therefore, is important to outline and explain the types of internal controls systems for this study.

5.3.2 Types of internal controls

- **Key control or primary control** are designed to mitigate the key risks related to the business objectives (Reding et al., 2009:6).
- **Secondary controls** are designed either to (1) mitigate primary risks, and (2) partially mitigate the level of risks when a key control does not work effectively (Reding et al., 2009:6).
- **Compensating controls** are designed to complete or enhance the key control and exist where ineffective internal control could be compensated for by another control (Cascarino & Van Esch, 2007:55).

- **Complementary controls** are controls that cannot work effectively on their own; they must be combined with one or more other controls to operate effectively (Reding et al., 2009:6).
- **Directive controls** are designed to encourage a desirable event to occur (Richard, 2009:9).
- **Preventive controls** are designed to deter and prevent undesirable events and prevent the potential risk before it happens (Moeller, 2005:73; Njeri, 2014:13).
- **Detective controls** are designed to deter and report risks before they occur (Njeri, 2014:13).
- **Corrective controls** are designed to inform or address every problem the system has encountered and involves follow-up and correction measures by the management (Lemi, 2015:14; Njeri, 2014:13).
- **Entity level controls** are defined by the Securities and Exchange Commission (SEC) as "aspect of systems of internal control that have a pervasive effect on the entity's systems of internal controls".
- **Information system controls:** Reding et al. (2006:6) outlined the two types of information systems controls:
  - **General computing controls** are designed to assist in ensuring the continuity and efficiency of operations, and it is considered as an entity-level control.
  - **Application controls** are computerised steps within the application software and other manual procedures to control the processing of several types of transactions.

5.3.3 SMEs implementation of internal controls

As stated by Perry (2016:5-7), small entities could have quality internal controls if the owner or management has a good attitude and behaviour and is committed to key controls. Lack of segregation of duties in small entities could result in ineffective internal controls, especially in operation and accounting, as employees might perform many functions, which could lead to the risk of misstatement due to irregularities. Furthermore, Perry (2016:7) stated the most effective key controls will highly be recommended to mitigate risks. According to Harrer (2008:98), small businesses face certain challenges when implementing internal controls effectively and efficiently, which include:

- the segregation of duties due to fewer employees;
- the possibility of management to override because of the ability to dominate activities;
- attracting boards of directors and audit committee members that are independent and have the expertise of the industry, operations, and financial matters;
- employing qualified accountants for reliable financial reporting;
- diverting a portion of management's attention away from running the business to providing adequate management focus on accounting and financial reporting; and
- Keeping up with IT.

Perry (2016:8) mentioned that COSO recognised that small entities could have quality internal controls systems, meaning that small entities can design and implement key controls, as it could lead to quality internal controls. The first step to risk mitigation and prevention is for the management or other authorised individuals to effectively carry out key controls (Perry, 2016:16).

5.3.4 Effect of weak internal controls

Management assesses risks as part of designing and operating the internal controls systems to mitigate risk (Hayes et al., 2000:259). Risk is bad and must be mitigated as soon as possible (Barlow, Helberg, Large & le Roux, 2000:125). Furthermore, Akani and MrOladutire (2013:7) mentioned that businesses suffer from irregularities so much that they end up losing their assets and even shut down due to irregularities related to weak internal controls. Effective internal controls contribute to the efficiency of the operation by mitigating and preventing risks such as the misuse of assets, wastage, and preparation of unreliable financial reporting (Njeri, 2015:1). Campbelle and Hartcher (2003:13) outline the results of weak internal controls:

- **Fraud:** businesses could lose millions because of fraud committed by employees or external parties, which could lead to shutting down the business.
- **Bad decisions for the business:** not reconciling bank accounts frequency could lead to overspending and the miss-use of cash, which could lead to insolvency.
- **Wrong decisions made by people ill-equip to deal with the situation**: unauthorised payments, not following procedures and proper supporting documents.
- **Not taking appropriate action:** failure to collect or take action when something such as overpayment occurs.

- **Not allocating resources of the business correctly or efficiently:** wasting time on trying to fix risk that could have been prevented if internal controls were designed and working effectively.

5.3.5 Purpose of internal controls

Barlow et al. (2000:119) claimed that the purpose of internal controls is to give management a reasonable assurance that the business objectives will be met. It is necessary for managing the organisation's performance and mitigating the risk that threatened the ability to achieve specific performance objectives. Donelson, Ege and McInnis (2015:1) mentioned that ineffective internal controls open a room for managers to involve themselves in fraudulent activities, mostly in entities with weak internal controls. Louwers et al. (2006:174) mentioned that design effectiveness determines the effectiveness of the operation of internal control, as it would prevent or detect irregularities. Internal controls systems are crucial for growth and the survival and effectiveness of business operations. According to Campbell and Hartcher (2003:5), the reason for internal controls are as follows:

- **Safeguard of assets:** internal controls are designed to protect the company's physical and monetary assets from irregularities.
- **Prevent and detect fraud and error**: internal controls assist the management with the efficiency of the operation by timeously deterring and preventing irregularities.
- **Help aligns objectives of the business:** internal controls assist with ensuring that the business is running effectively and efficiently through proper communication.
- **Promote good management:** internal controls assist with ensuring that the management receives information timely regarding the operation of the business.
- **Accountability:** internal controls assist with dealing with anyone who committed fraud or illegal activity to be accountable once it is detected.
- **Risk mitigation:** Internal controls are designed to mitigate irregularities or the likelihood of an unexpected event.
- **Ensuring proper financial reporting:** Internal controls are designed to ensure the reliability of financial statements required by management and legislation.

6. Research design

This study is a non – empirical research that used secondary data, which are literature from previous research papers and books. For this study, data were collected from various publications such as previous studies on the subject, journals, and textbooks. The advantage of secondary data is that it has been provided by a team of expert researchers and proved the opportunity to trace down the development over time, and it is used to compare with the primary data (Walliman, 2004:177). The total of 200 source of relevant literature was reviewed and examined to get a better understanding of SMEs and internal control systems and their connection or relationship with economic development of South Africa, which only 34 was used (see table 1).

Table 1. *Relevant literature sources consulted for the purpose of the research study*

Source Type	**Quantity**
Books	14
Website	11
Journals	7
Thesis	2
Total	**34**

Source: Own construction

7. Discussion

The current perception of previous researchers from the literature review is that SMEs do not implement internal controls to protect their businesses and dismiss the challenges that SMEs experience. The previous researchers had made it clear that SMEs fail and struggle to survive due to lack of management skills for the implementation of proper internal controls systems. This study has shown that the proper use of internal controls by SMEs significantly influences SMEs' survival, which positively influences the economy of South Africa by risk mitigation and risk prevention. A few studies investigated the real reasons and challenges that SMEs' leaders experience when implementing and using implemented internal controls systems.

The results from previous researchers do not have a better understanding of why SMEs' leaders struggle to implement an internal control system to mitigate and prevent risks. The literature review has also revealed suggestions for the implementation and utilisation of the internal controls to help mitigate and prevent risk in the SMEs. SMEs' leader should ensure that a controlled environment is their priority for effective business operation. Management should also know that although they are facing many challenges and limitations on the implementation and utilisation of internal control systems to mitigate and prevent risks, they can have effective control systems and effective utilisation of internal controls systems to mitigate and prevent risks. The concern is the perception of SMEs' leaders that the quality of internal controls can only be implemented by larger businesses. The study revealed that SMEs could also implement quality internal control systems such as larger businesses and improve their performance.

8. Recommendations and solutions

Controlled environment

The researcher recommends that SMEs' leaders should be aware that it is setting the tone at the top, as it controls the environment. In SMEs, employees have better chances of being influenced by top management, as they work closely with the management (Jackson and Stent, 2014:15). SMEs' leaders could use that as an advantage to positively influence effective implementation and utilisation of internal controls systems in the SMEs. SMEs' leaders should know that how the employees behave could be based on the leader's behaviour and attitude towards internal control systems. If the leader does not behave how he or she expects the employee to behave, the employee cannot behave as expected.

According to Kenechel, Salterio and Ballou (2007:227), management's behaviour and attitude are regarded as the most influential. If management has no idea about policies and procedures relating to risk mitigation, the control risk in the audit will likely be high, regardless of how effective internal controls design appear to be. In conclusion, SMEs' leaders should first practice what they preach. Due to the Small to Medium industry that could be affected by fewer employees, uneducated and semi-educated employees, complicated internal controls systems could put more strain on management and employees, which could lead to difficulties of adapting to new systems.

Management and employee training on the implementation and utilisation of internal controls systems

The researcher recommends that SMEs' leaders must be trained on the implementation and utilisation of internal controls systems before they place more expectations on employees. When SMEs' leaders know what to do and what is expected of them, they are in a better position to train their employees on the effective implementation and utilisation of internal controls systems to mitigate and prevent risks.

Management should use the COSO framework for better knowledge on internal controls systems and risks

The Committee of Sponsoring Organisation of the Treadway Commission (COSO) provides a broader understanding and guidance on internal controls systems and enterprise risk management. Leaders should use the COSO framework documents for the effective implementation of internal controls systems and get a better understanding of the components of internal control systems.

Furthermore, the COSO framework also guides SMEs' internal controls systems and enterprise risk management. SMEs' leaders could train themselves using the COSO framework documents available online. They could get a bigger picture of internal controls systems and risks, and they could be in a better position to train their employees. Furthermore, SMEs' leaders must be aware of the types of internal controls systems, how to implement them, and why they are implemented.

Implementation of key controls

The researcher recommends that SMEs' leaders should implement key controls. According to Reding (2009:6), key controls are designed to mitigate the risk concerning the business objective. The failure to implement efficiency and effective key control could lead to the failure of the business to achieve its objectives and survive. Key control systems are crucial for the survival of SMEs, as they relate to the risk concerning the main objectives of the business. When SMEs' leaders and managers prioritise the implementation of key controls, the business will not be exposed to high risks resulting in the closing of the entity.

Implementation of compensation controls

The study revealed that there is a challenge of implementing the segregation of duties due to fewer employees. The researcher recommends the implementation of compensation control. According to Reding (2009:6), compensation controls are designed to complete or enhance controls when they are not working effectively to mitigate and prevent risks on an acceptable level (i.e. close supervision when effective segregation of duties cannot be achieved). When SMEs' leaders and managers implement compensation control, they minimise the risks of lack of the segregation of duties.

11. Limitations of the study

This desk study used secondary data, which is literature from previous research papers and books. Due to limitations such as the lack of funding and resources, a field study could not be conducted. There is a need for a field study to investigate the phenomenon and obtain primary data to be compared with secondary data. Furthermore, concerning these identified limitations and factors, there is a need to understand the industry and the perception of SMEs, and qualitative studies are needed.

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