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Determinants of Internal Control Effectiveness among Selected Small and Medium Enterprises in Lagos Metropolis

Dr. Olufemi Aladejebi

Managing Consultant, Department of SMEs, The Great Business Clinic Ltd, Nigeria

Abstract:

The reason for this research was to establish the determinants of internal control effectiveness and performance among small and medium enterprises in Lagos metropolis. Internal control was measured using the five elements of internal control as instituted by the committee of sponsoring organizations of Treadway commission framework of internal controls. These elements are control environment, risk assessment, information and communication, control activities and monitoring. 150 questionnaires designed in modified Likert of 5 scales were distributed, and 142 responded. The data was analyzed using the mean scores and standard deviation. The study findings revealed that SMEs in Lagos metropolis involve strong internal control. This study recommended that SMEs owners should continue to maintain strong internal control system.

Keywords: Internal control, and small and medium enterprises (SMEs)

1. Introduction

Small and medium enterprises (SMEs) constitute over 90% of businesses in Nigeria (Adoyi, Agu, & Adoli, 2015) and account for more than 90% of total enterprise in Africa, the Caribbean, and Pacific countries (Adoyi, Agu, & Adoli, 2015). Therefore, their survival is critical to the development and boost of African economies (Ogundele et al.). Internal Control is a serious issue among SMEs. The adverse effect of internal control weakness can lead to loss of revenue, fraud, waste, loss of client and mismanagement. It can also lead to loss of business and inability of a firm to achieve set goals and objectives (Stones, 2016).

A very high proportion of the failed SMEs can be attributed to financial crisis resulting from poor internal control (Fatoki, 2014).

Internal control is critical to the survival of businesses, SME owners should improve on the internal control system of their firms (Frazer, 2016; Radzi, Nor, & Ali, 2017). Corporate fraud and business failures lead to greater demand for better internal controls among companies (Dimitrijevic, Milovanovic, & Stancic, 2015). The world financial crisis of 2007 and 2008 are examples of the need to strengthen the internal control for businesses (Kanagaretnam, Lobo, Ma, & Zhou, 2014).

SMEs are vital to the economic growth and equitable development in developing economies (Adoyi, Agu, & Adoli, 2015). In Nigeria, SMEs are important to the economy and a vital contributor to the Gross Domestic Product (Adoyi, Agu, & Adoli, 2015). Over 90% of all businesses in Nigeria are small businesses because they employ fewer than 100 employees (Etuk, & Etuk, & Baghebo, 2014). Lack of effective internal control systems was the reason why some SMEs failed during the financial crisis of 2007 to 2008 (Kanagaretnam, Lobo, Ma, & Zhou, 2014). The failure of SMEs was related to some managers' beliefs that According to Soininen et al., 2012, some managers believe that the establishment of internal control systems will increase costs without tangible results. Some SME owners also conclude that there is a shortage of human and financial resources. Therefore, it is difficult to establish internal control (Luyolo, Yolande, Juan-Pierré, & Wilfred, 2014).

2. Statement of The Problem

Many reasons can be adduced for lack of internal control. They include inadequate personnel, lack of qualified staff, cost of implementation, and inability to segregate duties (Feng, Mc Vay & Skaife, 2015). Cost control and increase in profit make SMEs not to invest in internal control (Jiahu, 2015). Small businesses are more prone to internal control failure compared to large organization. This failure to institute proper internal control process can lead to higher percentage of Turnover than large organizations (Andre, Pennington, & Smith, 2014). In recent years many companies have suffered severe losses and collapsed as a result of internal control failure (Al-Zwyalif, 2015). According to ACFE Survey in 2016, about 88.3% of large companies have an internal control system in place compared to 38.6% of small businesses (Stone, 2016, ACFE, 2016). SMEs account for substantial percentage of firms in African economies. The internal control system is a vital course of action that firms use to improve their organizations' attainment of goals and objectives, improve operational efficiency, strengthen

corporate existence, and improve competitiveness. The size and age of a firm are two important factors of the weaknesses in internal controls (Hsiung & Wang, 2014). Big companies seem to have better internal control system compared to Small organizations (Hsiung & Wang, 2014).

Segregation of duties is vital to an internal control system. Some small firms cannot implement segregation of tasks because of insufficient personnel and limited resources (Frazer, 2016). The weakness of internal control has an adverse effect on the profits and continuity of business (Adeniyi, & Adeniran, 2017).

3. Literature Review

3.1. Internal Control Theory

The concept of internal control was first, mentioned by the American Institute of Certified Public Accountants (AICPA) in 1949 (Frazer, 2011). Pang & Li, 2013 and White House, 2013 stated the 5 components of COSO internal control framework as: (a) control environments, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring (Pang & Li, 2013; Whitehouse, 2013). The first four components relate to the design and generation of the system of internal control while the fifth component ensures that internal control operates without hindrance (Missioura, 2014). In 1985, the COSO of the Treadway Commission introduced internal control on the presentation of financial reports, which assisted in improving internal control efficiency in smaller companies.

The fifth component ensures that feedback from monitoring is passed to management (Missioura, 2014) COSO of the Treadway Commission recommended the format for presentation of the financial report which is of benefit to SMEs by improving internal control. The COSO report of 1985 also recommends that owners of small businesses should establish internal control system in order to ensure that objectives are accomplished, operations effectiveness and efficiency, sound financial reporting and compliance with relevant laws and regulations (Leng & Zhao, 2013). Leng & Zhao; Saninen et al., 2012 stated that most companies are now adopting internal control for financial reporting, prevention of fraud and control of organizations. COSO advised that where there is no segregation of duties, there should be management examination and reconciliation to boost internal control (White house, 2013).

The most effective activity an organization can embark upon to minimize fraud is to improve its internal control practices (Leng & Zhao, 2013). Egbunike, 2014 observed that the greatest problem with internal control activities is the absence of controls. When separation of functions is lacking, COSO directs attention to the use of management examination and reconciliation to boost controls (Whitehouse, 2013).

3.2. The Effectiveness of Internal Control System

According to Frazer, (2012) internal control officers use the five components of COSO's internal control framework to detect, prevent, or correct errors or misstatements in the financial operations of the business. According to COSO, there are 17 principles under the five components of internal control framework. The full implementation of these principles is expected to lead to effective internal control among firms. (COSO Internal Control Framework, 2013).

3.3. The Components of Effective Internal Control Systems

3.3.1. Control Environment

Control Environment is one of the critical parts of a firm's internal control (Vu, 2016). Some of the components of control environment include the Board who is responsible for supervision of development and evaluation of internal control, the management team that formulates, put a structure in place, introduce policies and procedures and implementation of internal control policies (White House, 2013). There is a need for management to hire, train and reward capable staff of internal control unit. Also, COSO Internal Control framework, (2013) stated that management of organizations should make internal control officers accountable for their activities.

The control environment is very key as any lapse may result in fraud (Kachelmeier, Major & Williamson, 2014). Good control environment will lead to a reduction in errors and irregularities (Noland & Metrejean, 2013). Every firm needs to keep updating its internal control system as a result of a change in environment (Kachelmeier, et al., 2014).

Hypothesis 1: The greater the control environment is, the more likely that internal control systems will achieve more effectiveness.

3.3.2. Risk Assessment

Risk assessment is important; risk should be identified, analyzed, estimated and reviewed periodically (Asiligwa, 2017). Risk management framework should be set up to help improve the risk management practices and internal control (COSO to Internal Control framework, 2013)

Risk assessment can be classified as high, medium and low. This will determine the seriousness or handle each potential risk and which area need monitoring and proactive activities (D'Aquila and Houmes, 2014).

- Hypothesis 2: The greater the risk assessment is, the more likely that internal control systems will achieve more effectiveness.

3.3.3. Control Activities

Control processes are developed on identified risk in order to reduce the incidence of the risks happening. These controls are put in place in order to achieve the companies' objectives (COSO internal control framework, 2013). Control activities entail checking of authorization and approval, reconciliation, variance analysis of budgets and actual performance review (Vu, 2016). The identified risk may be prevented from happening through the institution of a sound internal control system (Muceku, 2014). Control activities may be manual or computerized. Before controls are established there should be a cost-benefit analysis, so that cost of control does not outweigh the benefits that will be derived (Gyebi and Quain, 2013).

- Hypothesis 3: The greater the control activities are, the more likely that internal control systems will achieve more effectiveness.

3.3.4. Information and Communication

Information is vital to the strategies a firm will use for internal control. The staffs of internal control need to know the companies' goals and objectives, strategy and the role internal control play in order to achieve these goals and objectives. Internal Control unit needs to communicate lapses noticed in the system to management and management will pass major information to the Board of Directors (COSO International Control Framework, 2013). Information and communication are very important in the internal control process (Vu, 2016). Every staff in an organization needs to know the role to play in the internal control process (Vu, 2016).

Hypothesis 4: The greater the information and communications are, the more likely that internal control system will achieve more effectiveness.

3.3.5. Monitoring Activities

Monitoring is vital in the Internal Control process (Zecheru, 2014). Monitoring can be used to know the effectiveness of the internal control process (Vu, 2016). The frequency of monitoring is dependent on risk assessment. The higher the risk, the higher the level of monitoring (Zecheru, 2014). The effective monitoring system should be able to detect weakness in the internal control system that is then communicated to the owners of the business (Vu, 2016).

- Hypothesis 5: The greater the monitoring is, the more likely that internal control systems will achieve more effectiveness.

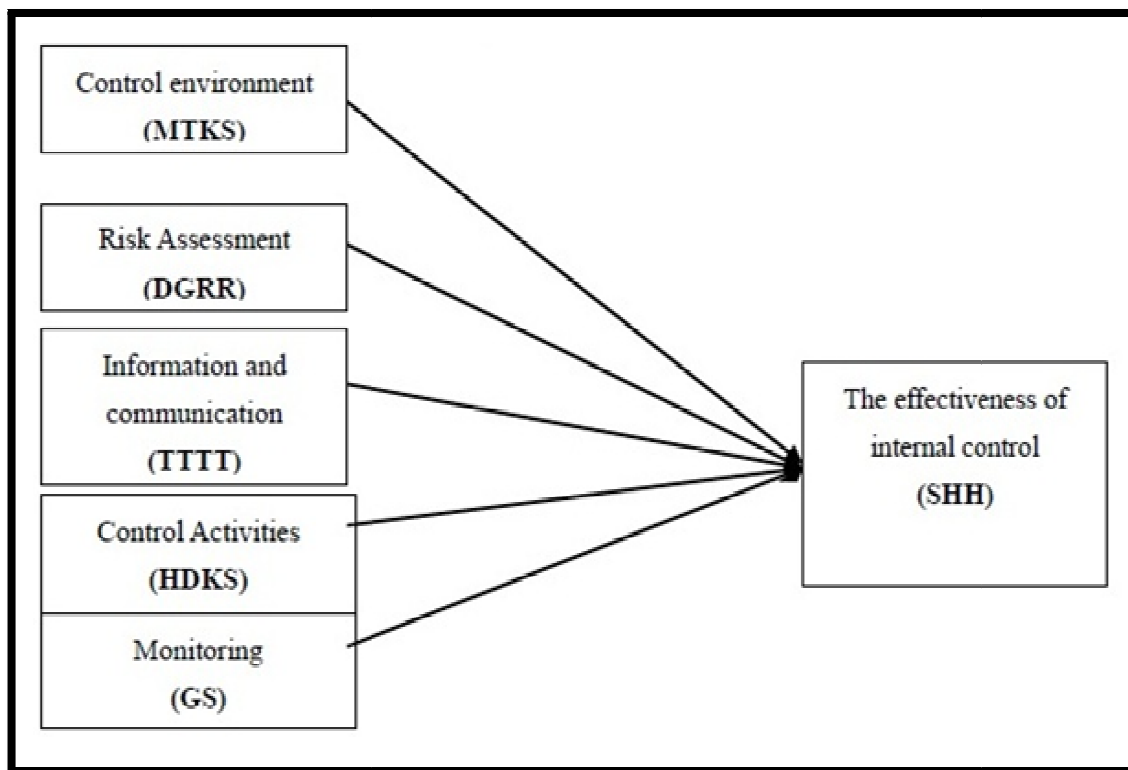


Figure 1: The Proposed Model of Factors Impacting the Effectiveness of Internal Control System among SMES in Nigeria

Source: The Model Proposed by Ho Tuan Vu, DUY Tan University

4. Method

The data was collected from the survey of 142 respondents out of 150 questionnaires distributed. SME owners participated in the survey. The study used a quantitative technique. The steps followed were: study design, data collection, and quantitative analysis using SPSS. The SPSS was used to present and analyze the data. 5-point Likert was used in the design of questionnaires: strongly agree (5) to strongly disagree (1).

5. Results

One hundred and fifty (150) questionnaires were distributed however complete data was collected from 142 Small and Medium Scale Entrepreneurs via self-administered questionnaires in Lagos, Nigeria. The questionnaire was formulated using a Likert scale ranging from Strongly Agree (5) to Strongly Disagree (1). The questionnaire was formulated to provide information on the determinants of internal control effectiveness.

Characteristic	Frequency	Percentage
Number of Distinct Products		
1-5	131	92.3%
6-10	8	5.6%
≥11	3	2.1%
Total	142	100%
Number of Employees		
2-10	103	72.5%
11-20	21	14.8%
21-30	4	2.8%
31-40	8	5.6%
41-50	2	1.4%
≥51	4	2.8%
Total	142	100%

Table 1: Characteristics of Entrepreneurs -A

The table above shows the characteristics of the entrepreneurs who participated in the survey. The majority (92.3%) of the entrepreneurs had 1 - 5 distinct products while 5.6% had 6-10 distinct products and only 2.1% had 11 or more distinct products. Most of the entrepreneurs (72.5%) had 2-10 staff in their employment, 14.8% had 11-20 employees, 2.8% had 21-30 employees, 5.6% had 31-40 employees, 1.4% had 41-50 employees while 2.8% had over 50 employees in their organization. It was quite surprising that as SMEs, quite a number of the entrepreneurs (12.6%) had more than 20 staff in their employment. However, it was explained that a lot of the staff were employed on contractual basis based on the nature of their businesses.

Characteristic	Frequency	Percentage
Legal Status		
Enterprise	42	29.6%
Limited	100	70.4%
Total	142	100%
Years in Business		
1-10	54	38%
11-20	73	51.4%
21-30	12	8.5%
≥31	3	2.1%
Total	142	100%

Table 2: Characteristics of Entrepreneurs -B

Majority of the entrepreneurs (70.4%) were limited liability companies while the remaining 29.6% were business names (Enterprise). Over half (51.4%) of the entrepreneurs had been in business for 11-20 years, 38% had been in business for 1-10 years, 8.5% had been in business for 21-30 years while only 2.1% had been in business for more than 30 years.

Characteristic	Frequency	Percentage
Industry		
Agriculture	4	2.8%
Engineering	21	14.8%
Consulting	19	13.4%
Education	3	2.1%
Arts (Fashion, catering, Graphics, etc.)	10	7%
Manufacturing	21	14.8%
Health	7	4.9%
IT	10	7%
Real Estate	13	9.2%
Trade	34	23.9%
Total	142	100%

Table 3: Characteristics of Entrepreneurs -C

The results of the survey showed a diverse number of industries in which the entrepreneurs operated under. The largest percentage was the Trade industry as 34% where into general trading, 13.4% were Consulting companies (this include advertising agencies, travel agencies, financial consultants, insurance consultants, etc.), another 14.8% were into Manufacturing, 14.8% were also in the Engineering industry which features construction, energy, electricity, marine, etc; 9.2% were into Real estate, 7% in the Arts industry, 7% in the ICT (Information Computer Technology) industry, 4.9% in the Health sector (pharmacies, hospitals, and health organisations), 2.8% in Agriculture and the least percentage (2.1%) in Education. This result shows the enormous diversity in entrepreneurship among SMEs in Nigeria.

S/N	Factors	Mean	Std Deviation
1	Our firm closely monitors the implementation of internal controls	4.6	0.744
2	Our firm provides feedback to the junior officers about the operation of the Internal Controls	4.37	0.821
3	Our firm has a code of conduct to guide behavior, activities and decision making	4.39	2.568
4	Our firm has an accounting and financial systems	4.27	0.868
5	Ethical values are upheld in all the firm's decisions	4.01	1.021
6	The board, the management, and employees are all committed to competence and integrity	4.03	0.930
7	There is an atmosphere of mutual trust in our firm	3.93	0.943
8	Roles and responsibilities are clearly stated for employees	3.99	1.035

Table 4: Control Environment Factors

The respondents were asked to grade their level of concurrence to how effective their business was with implementing the various indicators of control environment using the above Likert scale. Results from analysis of their responses showed positive means ranging from 3.93 to 4.6 with a standard deviation between 0.744 and 2.568.

S/N	Factors	Mean	STD Deviation
1	Our firm has defined appropriate objectives for the organization	4.37	0.895
2	Our firm identifies risks that affect achievement of the objectives in a timely manner	4.09	0.937
3	Our firm has criteria for ascertainment of the risks that are most critical to the organization	4.07	0.980
4	Our firm has in place mechanisms of mitigating critical risks that may arise during the course doing business	4.08	0.908

Table 5: Risk Assessment Factors

The respondents were asked to grade their level of concurrence to how effective their business was with implementing the various indicators of risk assessment using the above Likert scale. Results from analysis of their responses showed positive means ranging from 4.07 to 4.37 with a standard deviation between 0.895 and 0.980.

S/N	Factors	Mean	STD Deviation
1	Our firm has a clear separation of roles	4.18	0.845
2	Every employee's work checks on the others	3.82	0.987
3	The staff is trained to implement the accounting and financial management systems.	3.86	0.822
4	Corrective action is taken to address the weakness	3.94	0.861
5	Our firm has a well-organized chart of accounts	3.92	0.911
6	It is impossible for one staff to have access to all valuable information without consent from the senior staff	3.68	0.948
7	Controls are in place to check on incurring expenditure in excess of allocated funds	4.32	0.993
8	Departments undertake budget reviews and variance from budgeted expenditure are explained	4.18	0.965
9	Our firm's financial statements are regularly audited externally	3.99	1.035

Table 6: Control Activities Factors

The respondents were asked to grade their level of concurrence to how effective their business was with implementing the various indicators of control activities using the above Likert scale. Results from analysis of their responses showed positive means ranging from 3.68 to 4.32 with a standard deviation between 0.822 and 1.035.

S/N	Factors	Mean	STD Deviation
1	Our firm had identified individuals who are responsible for coordinating the various activities within the firm	4.08	0.923
2	All the employees understand the concept and importance of internal control including the division of responsibilities	4.09	0.798
3	Communication helps to evaluate how well the guidelines and policies of the firm are working and are implemented	3.86	.0795
4	The reporting system on the organizational structure spells out all the responsibilities of each department in the firm	3.85	0.984
5	Sufficient information is identified and communicated in a timely manner to enable people to perform their responsibilities	4.35	0.932

Table 7: Information and Communication Factors

The respondents were asked to grade their level of concurrence to how effective their business was with implementing the various indicators of information and communication using the above Likert scale. Results from analysis of their responses showed positive means ranging from 3.85 to 4.35 with a standard deviation between 0.795 and 0.984.

S/N	Factors	Mean	STD Deviation
1	Our firm has assigned responsibilities for the timely reviews of the audit reports and resolution of any non-compliance items noted in the audit reports.	4.19	0.922
2	There are independent processes, checks, and evaluation of control activities on an ongoing basis	4.04	0.999
3	Monitoring has helped in assessing the quality of performance of the firm over time.	3.95	0.955
4	An internal review of the implementation of the internal control system in departments is conducted periodically to ascertain its effectiveness.	3.96	0.922
5	Management is closely monitoring the implementation of the internal control system in our firm.	3.79	1.071

Table 8: Monitoring Factors

The respondents were asked to grade their level of concurrence to how effective their business was with implementing the various indicators of monitoring using the above Likert scale. Results from analysis of their responses showed positive means ranging from 3.79 to 4.19 with a standard deviation between 0.922 and 1.071.

Variable	Frequency	Percentage
Poorly Effective	0	0.0%
Average	33	23.2%
Highly Effective	109	76.8%
Total	142	100%

Table 9: Overall Effectiveness of Internal Control System

The overall level of agreement of the entrepreneurs to the various indicators of internal control effectiveness was scored and analyzed. The results show that none of the entrepreneurs agreed that their businesses' internal control system was poor or below average. The responses of 23.2% of the respondents reflected averagely effective internal control system while the majority (76.8%) agreed to have a highly effective internal control system based on the score of their responses.

Variable	Average n (%)	Highly Effective n (%)	P-Value
Industry			
Agriculture	2 (50%)	2 (50%)	0.806
Art	2 (20%)	8 (80%)	
Consulting	3 (15.8%)	16 (84.2%)	
Education	0 (0%)	3 (100%)	
Engineering	5 (23.8%)	16 (76.2%)	
Health	2 (28.6%)	5 (71.4%)	
Art (Fashion, Graphics, etc.)	3 (30%)	7 (70%)	
Manufacturing	7 (33.3%)	14 (66.7%)	
Real Estate	2 (15.4%)	11 (84.6%)	
Trade	7 (20.6%)	27 (79.4%)	
Distinct No of Products			
1-5	3 (23.7%)	100 (76.3%)	0.061
6-10	0 (0%)	8 (100%)	
≥11	2 (66.7%)	1 (33.3%)	

Table 10: Association between Internal Control Effectiveness and Characteristics of Entrepreneurs - A

The relationship between characteristics of the entrepreneurs and their internal control effectiveness was analyzed to determine the presence or absence of an association. The table above shows that SMEs in the education industry had the highest percentage businesses with highly effective internal control systems followed by real estate (84.6%), and consulting (84.2%) industry and Art with 80%. However, this association is not statistically significant as the P value (level of significance) is less than 0.05. The result also shows no statistically significant association between a distinct number of products and internal control effectiveness.

Variable	Average n (%)	Highly Effective n (%)	P-Value
No of Employees			
1-10	15 (14.6%)	88 (85.4%)	0.003
11-20	11 (52.4%)	10 (47.6%)	
21-30	2 (50%)	2 (50%)	
31-40	3 (37.5%)	5 (62.5%)	
41-50	1 (50%)	1 (50%)	
≥51	1 (25%)	3 (75%)	
Legal Status			
Enterprise	9 (21.4%)	33 (78.6%)	0.830
Limited	24 (24%)	76 (76%)	
Years in Business			
1-10	12 (22.2%)	42 (77.8%)	0.811
11-20	16 (21.9%)	57 (78.1%)	
21-30	4 (33.3%)	8 (66.7%)	
≥31	1 (33.3%)	2 (66.7%)	

Table 11: Association between Internal Control Effectiveness and Characteristics of Entrepreneurs - B

The relationship between characteristics of the entrepreneurs and their internal control effectiveness was analyzed to determine the presence or absence of an association. The table above shows that SMEs with 1-10 employees had the highest percentage of businesses with highly effective internal control systems. This association between having 1-10 employees and having a highly effective internal control system is statistically significant as P value is less than 0.05. There was no statistically significant association between the legal status of a business, years in business and internal control effectiveness.

6. Discussion

The study was carried out to define the determinants of internal control effectiveness among SMEs in Lagos suburb. The characteristics of the entrepreneurs showed that most of the entrepreneurs concentrated on being successful with a few numbers of distinct products (1-5). Although the majority of the businesses had 2-10 staff in their employment, a good percentage had over ten employees with some even having more than 50 persons in their employment. This shows that SMEs have a significant impact on the nation's economy growth especially in the area of job creation. Most of the businesses were limited liability companies which also reflects on the level of structure in place in these businesses.

6.1. Internal Control Effectiveness

The results of the study showed positive means ranging from 3.68 to 4.6 on all internal control indicators which include control environment factors, risk assessment factors, control activities factors, information and communication factors, and monitoring factors. This is similar to the results of the study by Rennox (2017). Although the entire scoring of the total internal control effectiveness was ranked from poor to highly effective, the result showed that no respondent agreed to have an ineffective internal control system however 23.2% were within average range while 76.8% were shown to have a highly effective internal control system.

In defining the determinants of internal control systems among the SMEs, the characteristics of the SMEs were cross-tabulated with their level of internal control effectiveness; the only number of employees was shown to have a statistically significant relationship with internal control effectiveness. Under this category, SMEs with 1 – 10 employees had the highest percentage of businesses that showed internal control effectiveness. Thus, it could be explained that the lower the number of employees, the easier it is to manage internal control systems. Based on this, a recommendation for SMEs with a more significant number of employees would be to segment the business into units and have staff that double as internal control auditors in each unit. This would aid in ensuring that every staff adheres to the company's ethics and standards and also result in effective internal control systems.

7. Conclusion and Recommendation

The study explained the determinants of internal control effectiveness among selected SMEs in Lagos metropolis. The result showed that to a large extent there was effective internal control among most of the respondents (76.8%) to ineffective internal control of 23.2%.

It is recommended that SMEs with a large workforce and different segments of business should be split into smaller units with internal control system maintained in each of these units. New business owners are encouraged to institute internal control system from the beginning of their businesses.

8. Limitations

The conclusion was drawn from 142 respondents out of several SMEs operating in Lagos metropolis. The study was restricted to SMEs in Lagos metropolis.

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