EXPLORING CHALLENGES IN DESIGNING AND IMPLEMENTING INTERNAL CONTROL SYSTEMS: A CASE STUDY OF SMALL AND MEDIUM ENTERPRISES IN THE CAPE METROPOLE, SOUTH AFRICA

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Abstract: Small and medium enterprises (SMEs) are pivotal in bolstering a country’s economy, particularly in South Africa, where high unemployment persists. In this context, studying SMEs’ survival becomes paramount as a potential remedy for alleviating economic poverty. Effective internal control systems emerge as crucial tools in this endeavour, serving as key mechanisms for risk management. They are instrumental in preventing fraud, safeguarding company assets, and ensuring the longevity and resilience of SMEs in challenging economic landscapes. Many SMEs design and implement internal control systems as a formality without fully considering their strategic objectives and potential impact on business operations. This research aimed to understand the challenges associated with designing and implementing effective internal control systems within SMEs in the Cape Metropole, South Africa. The study used a qualitative research methodology to collect data through interviews and employ thematic analysis for interpretation. The findings of this study shed light on the significant challenges faced by SMEs in the Cape Metropole, South Africa when it comes to designing and implementing effective internal control systems. These challenges highlight the limitations of the existing internal control systems within SMEs, particularly their capacity to fulfil crucial business objectives. Furthermore, this paper highlights a notable gap in SMEs’ comprehension and application of internal control systems, highlighting the need for effective, efficient, and tailored internal control systems to meet their unique business requirements.

Keywords: Internal Control Systems; SMEs; South Africa

INTRODUCTION

Small and medium enterprises (SMEs) have garnered global recognition for their substantial contributions to the economic development of nations. Mpofu and Sibindi (2022) underscore the pivotal role of SMEs in South Africa, where they serve as the linchpin of economic activity, driving job creation and sustaining GDP growth. Similarly, Weaven et al. (2021) acknowledge the significance of SMEs in fostering economic development across various Asia-Pacific countries, with a particular emphasis on India. Furthermore, Javed et al. (2022) highlight the essential role of SMEs in China’s sustained development and their contributions to economic growth. The World Bank’s extensive research has corroborated that active SME participation significantly influences economic growth and development, especially in developing nations (World Bank, 2020). Dörr, Licht, and Murmann (2022) affirm that SMEs are the backbone of Germany’s economy, benefiting
from comprehensive and well-distributed support measures.

Despite their paramount role in global economic development, SMEs grapple with vulnerabilities such as fraud, theft, financial irregularities, and corrupt practices, jeopardising their survival and expansion (Adewumi and Isaac, 2023). South African businesses, in particular, have faced accounting scandals ranging from financial fraud to misappropriation of assets, posing significant threats to SMEs’ sustainability and reputation (Sewnath and Niemand, 2018). SME managers must implement effective and efficient protective measures to safeguard their businesses and achieve their objectives.

Surprisingly, prior research has overlooked the nexus between SME managerial qualities and risk management, focusing predominantly on larger organisations (Chakabva and Tengeh, 2023). Studies examining the impact of internal control systems on business survival and sustainability have primarily centred on large firms, with limited attention devoted to SMEs (Ajala et al., 2023). Neglecting the organic integration of internal control and risk management, vital tools for assessing an organisation’s health before risks become critical has been a common shortcoming in the literature (Jackson and Stent, 2020). Moreover, numerous challenges surround the design and implementation of internal control systems within SMEs, primarily stemming from management’s lack of understanding of their significance or inadequate system design and implementation (Vu and Nga, 2022). The Institute of Internal Auditors (2020) and Bamata and Phiri (2022) have unequivocally stated that SMEs’ sub-par internal control systems can precipitate financial crises, leading to business failures. Using SMEs from the Cape Metropole, South Africa, this study provides an understanding of the internal control systems design and implementation challenges and their efficiency and effectiveness in achieving business objectives.

LITERATURE REVIEW

Financial irregularities, fraud, and internal control systems within SMEs

Financial irregularities and ineffective internal control systems within SMEs harm their business operations. Among the various consequences, low employee morale is a prevalent contributing factor to fraud in SMEs characterised by weak internal control systems (Zainal et al., 2022). Remarkably, the literature on fraud within SMEs remains limited despite their substantial contributions to economic growth and development.

Senvar and Hamal (2022) affirm that financial statement fraud has far-reaching repercussions, undermining sustainable economic development and impeding the attainment of organisational and industry goals. Fraud is identified as a pervasive accounting challenge encountered by SMEs. Moreover, it is crucial to recognise that fraud in accounting can impact a broad spectrum of stakeholders, including employees, partners, SME owners, and government entities. This impact is attributed to the pivotal role of accurate and trustworthy accounting records for all stakeholders’ interests (Doğan and Hamidow, 2022).

Napitupulu (2023) denoted the necessity for a high-quality accounting information system achievable through
effective internal controls and competent managerial oversight. The effectiveness of the accounting system’s management hinges on the competency of managers who design and implement internal control systems tailored to the specific needs of their businesses.

Managerial competency in SMEs
Numerous studies have stressed the significance of managerial competency in the context of SMEs. Financial literacy, a vital component of managerial competency, is often lacking among entrepreneurs worldwide. Anshika and Singla (2022) cited the role of financial literacy in enhancing SME performance, particularly when access to sufficient funds is crucial. Insufficient funds can profoundly affect operational efficiency and hinder the growth and survival of SMEs.

Research conducted in SMEs has identified various managerial skills significantly impacting SME performance, including technical, conceptual, interpersonal relationships, and budgeting skills. Orji et al. (2023) conclude that lacking managerial skills can hinder SME performance, emphasising the importance of understanding, leading, effecting change, and regulating individual behaviours for SME managers. Eniola and Entebang (2017) concur that SME management often lacks financial knowledge but suggests that a shift in financial attitude stemming from improved financial literacy can lead to enhanced business performance. Additionally, Tuffour et al. (2022) support the notion that financial knowledge among SME leaders improves performance and influences entrepreneur decision-making and their relationship with financial attitudes, comparing these aspects with financial literacy.

Timothy (2022) identifies technical competence, an international perspective, and change management as three pivotal elements of managerial competence essential for SME managers. Furthermore, Anoke et al. (2022) and Winterton (2002) emphasise the necessity for SME managers to possess international experience, knowledge, and technical competencies. These competencies are deemed invaluable for successfully implementing new technologies and designing and implementing internal control systems.

Design and implementation of internal control systems
According to COSO (2013), internal control refers to procedures established by organisational leaders with the primary objective of assessing performance. The utilisation of internal control systems predominantly centres around three key goals:

- Safeguarding organisational assets: Internal controls aim to protect the organisation’s assets, ensuring their integrity and security.
- Compliance with legislation and regulations: Another critical objective is to ensure compliance with relevant laws and regulations, mitigating legal risks and liabilities.
- Accuracy of financial records: Internal controls are instrumental in maintaining the accuracy and integrity of an organisation’s financial records.

These objectives collectively enhance the reliability and integrity of financial and operational information. They also promote the efficient execution of operational activities, effective decision-making concerning assets and organisational
matters, and adherence to applicable laws and regulations (COSO, 2020; Wu et al., 2023).

In supply chain finance, Chand (2022) emphasises the importance of detecting fraudulent enterprises and transactions as a crucial measure to minimise financial losses. Siallagan (2022) further suggests that to prevent fraudulent activities effectively, it is imperative to design and implement robust internal control systems and bolster organisational commitment to their implementation. The evidence of fraud occurrences in various sectors, spanning government and the private sector, underscores the critical nature of designing and implementing internal control systems across all sectors.

The impact of efficient and effective internal controls on achieving business goals
The disadvantages and repercussions of failing to design and implement efficient and effective internal control systems highlight the paramount importance of these systems in optimising organisational operations. It becomes evident that effective and efficient internal control systems are indispensable for the smooth functioning of any organisation.

A study by Nguyen, Vu, and Bui (2023) yielded findings highlighting the positive impact of internal control factors on the utility and reliability of accounting information. Moreover, internal control is an evolving process strategically designed to aid management in attaining an organisation’s operational and financial objectives (Chang et al., 2019). COSO (2020) corroborates the significance of designing and implementing an effective and efficient internal control system by affirming that it furnishes reasonable assurance in achieving three fundamental objectives: enhancing the effectiveness and efficiency of operations, streamlining processes, and ensuring optimal resource utilisation, ensuring the reliability and accuracy of financial and operational reporting, strengthening the integrity of the information presented; and facilitating compliance with pertinent laws and regulations, safeguarding the organisation from legal risks and liabilities. This evidence signifies the pivotal role of internal controls in organisational success.

Finally, the literature review emphasises the need for this study, highlighting the significance of addressing the design and implementation of effective internal control systems within SMEs. The identified gaps and challenges in SMEs call for a deeper investigation to provide valuable insights and recommendations for these enterprises’ sustainability and growth.

METHODOLOGY
This study adhered to a qualitative research paradigm, employing a case study-based approach. Qualitative research is instrumental in uncovering novel insights by delving into the intricacies of relationships, activities, and contextual situations (Islam and Aldaihani, 2022). In line with Maxwell’s (1996) perspective, qualitative research often seeks to understand how one variable (x) influences another (y) and explores the nuanced relationships between them. In the context of this research, the central inquiry revolves around understanding the challenges associated with designing and implementing effective internal control systems within SMEs within SMEs in the Cape Metropole.

Qualitative research necessitates the selection of a sample that can yield rich insights into the phenomena under investigation. This study employed purposive convenience sampling to fulfil
its research objectives. Purposive sampling entails the deliberate selection of individuals or groups most likely to provide the data necessary to achieve the study’s objectives (Marre, 2007). In essence, this approach focuses on capturing the perspectives of those individuals who can best contribute to meeting the research goals. The target population for this study comprised the owners and managers of SMEs within the Cape Metropole.

In-depth interviews served as the primary data collection for this study, employing a thematic approach to address the research problem under investigation. The research was conducted within the selected SMEs in the Cape Metropole region. In alignment with the qualitative research approach, a targeted sample of nine SMEs, all of whom willingly participated in the study, was approached for interviews.

The interviews were conducted with careful consideration for the participants’ time, ranging from 30 to 50 minutes each. During these interviews, respondents were given the autonomy to articulate their experiences and insights concerning internal risk control scenarios. A semi-structured questionnaire guided the discussions, ensuring a systematic exploration of the pertinent themes.

The data for this study were derived from a convenience sample comprising senior operations and finance managers, as well as leaders of SMEs. The credibility of the data was bolstered through various means. Firstly, an extensive literature review and theoretical inquiry were employed to construct the semi-structured interview instrument (Crouch, 2012). This ensured that the questions posed during interviews were rooted in existing knowledge and research, enhancing the reliability of the collected data.

Furthermore, the flexibility and semi-structured nature of the interviews allowed participants to express their perspectives, share insights, and elaborate on the subject matter. This approach facilitated natural and in-depth conversations that could organically explore unexpected avenues, all within the context of risk control elements explicitly explained to the participants. Using recorded in-depth interviews added a layer of credibility to the findings, ensuring that the data was accurately captured and could be reviewed as needed.

The data analysis process involved the interpretive classification of challenges related to internal control design and implementation into distinct categories. This analytical approach included breaking down the data to identify emerging themes, sequences, processes, patterns, and holistic insights, all guided by the insights gained from the extensive literature review. This comprehensive approach to data analysis ensured that the findings were credible and deeply insightful, allowing for a nuanced understanding of the challenges associated with the proper design and implementation of internal control systems within SMEs.

RESULT AND DISCUSSION
The findings of this study provide valuable insights into the intricate challenges faced by SMEs in the Cape Metropole, South Africa, during the design and implementation of internal control systems. These challenges encompass various facets of SME operations and underscore the critical importance of addressing them to ensure the effectiveness and sustainability of internal control systems.

- Training challenges: The theme
highlights the significance of equipping SME leaders and staff with the requisite knowledge and skills for successful internal control system implementation. The issues identified, such as time-consuming training processes and cost implications, emphasise the delicate balance SMEs must strike between investment and resource allocation. Moreover, the attitudes of management towards training play a pivotal role, as proactive support for training initiatives is essential. SMEs should view training as an investment in the long-term viability of their businesses.

- **Implementation risks:** The theme of implementation risks delves into the potential obstacles encountered during the execution of internal control systems. These include errors in the implementation phase, employee resistance, concerns about staff adaptation, and fears of disruptive change. Resistance to change hinders the successful implementation of internal controls. SMEs must adopt change management strategies and transparent communication to mitigate these risks effectively.

- **Operational hurdles:** Operational hurdles encompass challenges related to work policies, human errors, system manipulation, and compliance issues. These factors can have a direct impact on day-to-day SME operations. Inconsistent work policies lead to employee dissatisfaction, while human errors and system manipulation can compromise data integrity. Ensuring fairness, accuracy, and strict adherence to guidelines is paramount for the effectiveness of internal control systems.

- **External influences:** External influences, including economic volatility, environmental shifts, and technological advancements, highlight the dynamic nature of the business environment. These external factors pose challenges beyond SMEs’ control. To navigate these influences successfully, SMEs must proactively adapt to changing circumstances and leverage technology to enhance internal controls.

- **Internal factors:** Internal factors encompass inherent business risks, outdated IT systems, staffing challenges, and employee skill levels. These internal challenges directly impact SMEs’ ability to design and implement effective internal control systems. Addressing inherent risks, updating IT infrastructure, investing in staff development, and recruiting skilled employees are critical steps for SMEs to overcome these hurdles.

- **Strategic considerations:** Strategic considerations focus on potential reputational risks and the importance of monitoring systems. The reputation of SMEs can be vulnerable to internal control failures, affecting customer trust and stakeholder confidence. Robust monitoring systems are essential for detecting and responding to internal control weaknesses and safeguarding SMEs’ reputations.

- **Financial implications:** Financial implications encompass legal and regulatory risks, negative financial outcomes, and potential losses from
investments in new systems. These financial risks indicate the tangible impact of internal control deficiencies on SMEs’ financial health. Compliance with legal requirements and diligent risk mitigation are imperative to protect SMEs from adverse financial consequences.

The themes identified in this study provide a comprehensive understanding of the multifaceted challenges and risks faced by SMEs in the Cape Metropole, South Africa, during the design and implementation of internal control systems. Addressing these challenges necessitates a holistic approach that includes training, change management, operational excellence, adaptability, and strategic thinking. By proactively addressing these themes, SMEs can enhance their internal control systems capabilities and increase their likelihood of achieving operational goals and long-term success.

CONCLUSION

This study sheds light on the multifaceted challenges SMEs face in designing and implementing effective internal control systems. These challenges encompass various aspects of training, implementation, operations, external factors, internal dynamics, and strategic considerations. The findings emphasise the critical role of internal control systems in the survival and growth of SMEs and highlight the complexities associated with their design and implementation.

SMEs are the backbone of many economies worldwide, contributing significantly to job creation and economic development. However, the identified challenges in internal control systems hinder their ability to protect themselves from threats such as fraud, theft, financial irregularities, and corrupt practices. These challenges can impede SMEs’ progress, affect their financial stability, and erode their reputation.

To address these challenges, SMEs must receive support from various stakeholders, particularly the government and industry players. Financial assistance should be extended to facilitate the implementation of robust internal control measures. Accessible training programs should be provided to enhance SME leaders’ and staff’s knowledge and capabilities, promoting a risk management and compliance culture.

Operational hurdles, both internal and external, must be addressed diligently. SMEs should invest in clear work policies, accurate data management, and compliance with regulations. Updating information technology infrastructure, recruiting skilled employees, and investing in staff development are essential to overcoming internal challenges. Moreover, safeguarding reputation through robust monitoring systems and effective risk management strategies is crucial for building and maintaining stakeholder trust.

In light of the findings, promoting industry collaborations and partnerships can facilitate knowledge sharing and provide resources to help SMEs navigate the complexities of internal control systems. Mentorship programs or connections with experienced professionals in risk management and internal control systems (i.e., COSO) can offer valuable guidance and support to SMEs.

By implementing the recommendations from this study, SMEs can enhance their internal control systems capabilities, ultimately increasing their
chances of success and sustainability in the competitive business landscape. Addressing these challenges is vital for SMEs’ survival and their ability to thrive and contribute to economic growth and development.

REFERENCES


