EFFECTS OF INTERNAL CONTROL PRACTICES ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY

BY

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN FINANCE, UNIVERSITY OF NAIROBI

NOVEMBER 2016

DECLARATION

This research project is my original work and has not been presented at any university or institute of higher learning for examination or academic purposes.

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This research project has been submitted for examination with my approval as the University supervisor.

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ACKNOWLEDGEMENTS

I wish to express my sincere gratitude to my supervisor Dr. Kennedy Okiro for the guidance and advice which enabled me to carry out the research effectively.

I also wish to express my gratitude to the Small and Medium Enterprises owners and employees who took time to give out data through questionnaires I administered to them which aided my data collection, I am grateful for their cooperation.

I also thank my Family and friends for their encouragement throughout my study.

DEDICATION

This project is dedicated to my family and friends who encouraged me during the study period. It's also dedicated to all the small and medium Enterprises who will find it useful to use and follow the research advice and findings for their own help.

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ABBREVIATIONS

F- test - Fishers test

GoK - Government of Kenya

IFAC - International Federation of Accountants

SMEs - Small and Medium Enterprises

t-test - Students t test

ABSTRACT

SMEs play a vital role in an economy of any nation more especially the developing ones. However, SMEs are still finding it hard to survive and compete with other well established firms despite their contribution to an economy as a whole. As such, an effective internal control in SMEs has the potential of reducing employees' fraud leading to success of SMEs in achieving its objective and goals, which is creation of more profits. This study examined effects of internal control practices on performance in financial perspective of SMEs within the county of Nairobi. A descriptive research design was adopted in the study. Population of this study comprised of all SMEs in Nairobi County. Using simple random sampling technique a sample of 100 SMEs was randomly selected. Both primary data and secondary data were utilized in the study, which was collected using self-administered questionnaires and secondary data on performance in financial perspective of SMEs was collected from SMEs financial reports. The results established that the control environment and risk assessment had a negative relationship with financial performance of small and medium enterprises. The results also revealed a positive relationship between control activities and information and communication and monitoring and financial performance financial performance of SMEs in Nairobi County. The study concluded that there is an inverse relationship between financial performance of SMEs in Nairobi County and the control environment and risk assessment. The study also concluded that there is a direct relationship between control activities, information and communication, monitoring and the financial performance of SMEs in Nairobi County. The study recommended that SMEs should ensure there they have a good environment control, effective assessment of risk and control activities and proper monitoring strategies.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

SMEs constitute majority of entities in the world and account for a great portion of total employment and total production (Hussain, Millman & Matlay, 2006). SMEs play a great role in an economy. SMEs are income generating entities to their owners, sources of national outputs and revenues as well as acting as feedstock for large entities or firms (Olatunji, 2013). SMEs have a great significance going by a fact they account for 90 percent of entities and 60 percent of employment opportunities all over the world. Due to the current increase in both unemployment levels all over the globe, SMEs are providing an alternative to conventional industrialization (Mutandwa, Taremwa & Tubanambazi, 2015).

Reasonable assurance concept affirms that a high level of assurance, constrained by benefits and costs of setting up an incremental control procedures which have the potential of leading a high performance level of SMEs (Shanmugam, Haat & Ali, 2012). Thus, internal control is a vital part of management process by which entities manage their activities and operations so as to accomplish their missions and objectives in an effectively and efficiently manner (IFAC, 2012). Internal controls have the potential of providing a reasonable assurance and not an absolute assurance in regard to achieving the entities set goals and objectives. Implementation of a proper system will enable an entity to operate in more effective and efficient manner (Sulaiman, Siraj & Mohamed, 2008). It is difficult for entities to know if they have complete and accurate information if they lack proper internal (Long, 2009).

The adoption of a strong and effective internal control system in an entity is crucial for a safe and sound management of an entity. An entity is always vulnerable to many risks if it lacks adequate internal controls. The risks that may be caused by improper records of accounting transactions and making unauthorized transactions may significantly affect the entity's performance more especially in financial perspective (Dumitrascu & Savulescu, 2012). An entity can benefit more if it has an effective internal control. With a proper internal control system, an entity can be in a position to comply with laws and regulations in a smooth way as compared to an entity that doesn't have a proper system of internal control (Shanmugam, Haat & Ali, 2012).

1.1.1 Internal Control Practices

Internal control practices aim at complying with internal control standards which were developed by a central authority. Internal control is only effective if the following components are well incorporated; environment control, assessment of risk, monitoring, communication and information and control activities (Sampson, 1999). The overall success and performance of a system of internal control depends on how well each component of internal control are functioning as well as how they are coordinated with each other (Oseifuah & Gyekye, 2013).

Environment control is all about the factors which have the potential of determining the effectiveness levels of policies, procedures, and methods specific to the process. Moreover, the environment control also refers to a value, which a firm's management attaches to importance of audit and management of risk functions (Boame, Solace & Issaka, 2014). Environment control is a main aspect of entity management since it reflects the attitude

and management policies regarding the importance of internal audit in economic unit (Theofanis, Drogalas & Giovanis, 2011).

Assessment of risk is about identification of relevant risks and the analysis of such risks to achieve the objective of forming a better basis on how to well manage such risks. Assessment of risk is a process of integrating a professional judgment about the potential of adverse events or conditions, and assessment of the likelihood of a possible loss (Ndamenenu, 2011). The main aim of carrying out a assessment of risk is to determine any situations which may pose a legal or financial risk to a firm (Boame, Solace & Issaka, 2014). In such case or situation, the firm's management must be able to determine an acceptable level of risk carefully, and try to maintain the risk within determined levels (Badara & Saidin, 2013).

Control activities refer to policies and procedures which ensure that the management directives are carried out to the later. They ensure that necessary actions for addressing risks are taken so as to achieve the entity's set goals and objectives (Mwakimasinde, Odhiambo & Byaruhanga, 2014). Components of control activities describes every policy, procedure and the best practice a firm especially small ones can put in place so as to minimize risk (Boame, Solace & Issaka, 2014). Example of control activities may consist of; segregation of duties, daily, bank reconciliations and so on (Badara & Saidin, 2013).

Communication and Information -systems or processes which support identification, capture, and information exchange in a form and period which enables people in carrying out their responsibilities (Ndamenenu, 2011). Information is usually seen as a vehicle in which control procedures, policies are presented, and reinforced. On the other hand,

communication is a mean by which employees are made aware of management's commitment to internal controls (Oseifuah & Gyekye, 2013). Information must be conveyed throughout entire entity so as to permit personnel to effectively and efficiently carry out their responsibilities with an aim of achieving the entity's set goals and objectives (Badara & Saidin, 2013).

Monitoring deals with assessment of performance of internal control over period of time. It is usually done by an ongoing monitoring activities and by evaluations of intern control like self-assessments (Ndamenenu, 2011). Monitoring aim at determination of whether internals control within an entity are adequate, properly executed, and effective (Sampson, 1999).

1.1.2 Financial Performance

Financial performance is firm's ability to generate new resources, from its daily procedures, for a certain time period. Financial performance may also refer to the firm's ability to make good use their resources in an effective and efficient manner for achievement of the firm's objectives and goals (Stoner, 2003). According to Kagoyire and Shukla, (2016) financial performance is the firm's ability to efficiently operate, be more profitable, to grow and survive for a long period of time. All organizations strive to utilize it resources effectively to achieve a high performance level especially in financial terms. Thus, financial performance is the outcome of any of many different activities undertaken by an organization (Han, 2014).

Financial performance is an indication of how a firm can utilize its current assets from the firm's main business mode and operations and generate revenues for the business (Stoner, 2003). Financial performance also shows how health a firm is in financial terms over a certain period. Financial performances is applied in weighing up firms from same industry or in comparison to other firms in different industries or sectors with intention to come up with a decision on how to improve on the prevailing situation or sustain a desirable position within the market (Akinruwa, Awolusi & Ibojo, 2013).

Financial performance measurements are essential for accountability and strategic planning. Performance measurement deals with a measure on how well firms are managed in relation to set targets and the generate values to the firm's stakeholders (Han, 2014). There exists different ways that SMEs can adapt to in order to improve their financial performance, though all these systems adopted should be considered in aggregation. Items like revenue, income from operations or firm's cash flows, total sale units and so on.

Measures of financial performance includes key business statistics like new orders received by the business, efficiency in cash collection, Return on Investment (ROI), Return on Asset (ROA) that measure the firm's performance in some important areas. Key performance indicators show that, the progress (or lack of it) towards achieving the objectives of the firm is by monitoring those activities that (if not properly done) are likely cause heavy losses or an outright failure of the firm's business. SME are expected to be profitable and there are some checks on profitability such as whether a firm has made a loss or profit on its ordinary or normal activities and by how much this year's loss or profit is higher or lower than the previous year's loss or profit. Profitability measures involves sales margin

which is turnover less the cost of sales, earnings per share (EPS) is refers to the profit attributed to each ordinary (equity) share (Han, 2014).

Measuring firm performance also provides information and means to achieve sustainable growth. Moreover, it drives a company to positive changes, even more as the evaluation of firm performance is commonly implemented for the purpose of improvements. Firm performance could mean the success level of the firm in the market within which it operates. It could also be described as the ability of the firm in creating commendable profit (Han, 2014).

Financial performance is measured by use of many ratios and models like the return on investment, profit margin, efficiency ratios, liquidity ratios etc. (Han, 2014). A firm's overall and comprehensive performance is measured by the use of ROA from an accounting perspective. ROA basically the ratio of Income of the firm to the firm's total asset (Han, 2014),

1.1.3 Internal Control Practices and Financial Performance

Control is a major task which squarely lay on the shoulders of the firm's owners' or the management. Internal control on SMEs is very crucial since it plays a great role on SMEs performance in general (Uzun, 2011). Systems of internal control play an important role in every organization as it assist in realization of their financial performance goals. As such, strong and effective internal control system has the potential of strengthening a firm's governance, help in achievement of set goals and objectives by the management and risk mitigation (Shanmugam, Haat & Ali, 2012). IFAC (2012) posits that effective internal

control has a potential of creating a competitive advantage since a firm with an effective control system is able to take on additional risk.

Jensen (2003) systems of internal control and practices comprising of internal audits are aimed at enhancement of reliability of performance in financial perspective by simply increasing accountability among providers of information in a firm. Sanusi et al. (2015) assessed internal control effectiveness, financial management and accountability practices of mosques in Malaysia and revealed that systems of internal control and enhances the performance of Malaysian Mosques to achieve their mission and goals.

A study by Muraleetharan (2011) assessed whether internal control system can lead to an increased performance in financial perspective of organizations. The findings of the study established that internal control and performance in financial perspective are statistically significant and a positive relation between communication and information, environment control and performance in financial perspective.

1.1.4 SMEs in Nairobi County

SMEs are defined as business entities with 5 to 50 staffs or those entities which an annual revenues of less than Kes. 50 million. SMEs is one of the largest sector in Kenyan economy since it employs many Kenya's workforce as well as contributing up to 18.4% of Kenyan's GDP. In Kenya, the number of SMEs has been rising at a very high rate in last two or so decades with many of them based in rural areas of Kenya. SMEs sector has made an exceptional contribution to Kenyan economy (Oseh, 2013). As such, SMEs are a vast majority of business entities found in Nairobi City County and they have created employment for a large portion of the workforce in Nairobi County.

In Kenya, an SME is defined as an entity that is not generally accountable to the public; does not publish its financial statements for general external users and whose equity and debt instruments are not publically traded or even over the counter market or traded in a foreign stock exchange (ICPAK, 2009).

Small businesses like enterprises are mostly likely to have some internal controls to help them protection of their assets as well as a reduction in risk of fraud (Jiang, 2010). Thus, understanding of the internal controls system and how the system works by SME owners can help protect their small enterprises against fraud and embezzlement. With a proper system of internal control, SMEs would be able to use their financial resources in a manner that will help in safeguarding owners' interests. Thus, internal control system is able to provide a reasonable assurance, but not an absolute assurance which SMEs objectives are likely to be met (Neneh & Zyl, 2012).

1.2 Research Problem

SMEs play very vital role in economy of any nation particularly for developing nations and economically emerging nations (Chakraborty, 2015). Majority of SMEs are really struggling to survive. Those that are able to survive are still performing so badly despite their crucial contributions to the entire economy (Neneh & Zyl, 2012). As such, an effective internal control in SMEs has the potential of enabling them to succeed and reducing employee fraud (European Federation of Accountants, 2014). However, many small businesses comprise of only the owners of business with possibly one or two executives and some few employees who focus on the business performance and not accounting and undervalue the importance of strong internal controls (Long, 2009).

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Kenyan SMEs have a high failure rate with many of them failing within the first three years of operation (Njaramba & Ngugi, 2014). Past statistics in Kenya indicate that 3 out of 5 business entities fail in first few months of their operation (Government of Kenya, 2007). As such, Kinyua (2014) posit that due to agency problem arising from SMEs owners and employees, small businesses in Kenya fail to grow and flourish, and the rate of business entities failure continues to rise.

Several studies have also been undertaken on the effect of internal control on performance. For example, a study by Oseifuah and Gyekye (2013) investigated internal controls effectiveness in South African SMEs and revealed internal control practices among SMEs in South Africa was very low, with only a few of them having adequate internal controls systems in place. Dineshkumar and Kogulacumar (2013) also studied an extent to which systems of internal control influence a firm's performance and revealed a strong relation between systems of internal control and firm's performance of Sri Lanka Telecom limited but the study did not focus on effect on internal control practices on SMEs performance.

In Kenya, Kamau (2014) examined effect of systems of internal control on performance in financial perspective of manufacturing firms and established a positive relation between internal control and performance in financial perspective, however; the study was based on large manufacturing firms hence its findings may not be generalized to the SME context. Most of the reviewed empirical studies indicate that internal controls are vital to any business organization. However, despite a fact that internal control is a vital factor affecting a firm regardless of its size, there is little evidence on the effect of internal control practices on performance of SMEs since most of studies on internal controls globally and in Kenya focus more on large firms than SMEs. Thus, a literature gap, which this study intends to

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determine by examining; what are effects of internal control practices on performance in financial perspective of SMEs in Nairobi County?

1.3 Objective of the Study

To examine effects of internal control practices on performance in financial perspective of SMEs in Nairobi County

1.4 Value of the Study

This study is of great significance to SME owners and managers in their decision-making on effective and proper internal control practices, which assist them to improve the performance of their SMEs. In addition, SME owners and managers may use the study recommendations to make improvements on their internal controls.

This study is also of value to policy makers including Government of Kenya and Ministry of Industrialization and Innovation to develop policies on internal control implementation by SMEs. Finally, this study is of importance to future and present researchers who will find this study finding useful in their area of study especially on SMEs' internal controls and performance.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

Chapter two focuses on the existing literature by different authors on the internal control and performance with a view to understanding the various approaches as well as stimulating new ideas about the study area. The chapter outlines the theoretical literature review, the determinants of SMEs performance, the empirical literature and finally a literature review summary.

2.2 Theoretical Literature Review

The study draws on the agency theory, the contingency theory and the systems theory as theoretical framework that guided this research.

2.2.1 Agency Theory

The theory of agency exists when the principle who cannot manage his business on his/her own delegates the authority to an agent (Jensen & Meckling, 1976). The problem with agency arises immediately when the desires and the goals a principal and the agent conflict. It is very tough and difficult or rather expensive for a principal to always monitor the work of his/her agent to ensure that the agent works and makes some decisions on the best interest of the principle. Thus, the theory of agency is help in solving the principle and agent issues with an aim of ensuring a better relationship between them (Arwinge, 2013). This theory is based on the notion that the interests of shareholders and the managers are not aligned in a perfect away to enable them work for a common goal which is achieving the organizational set goals and objectives. The agency theory plays a crucial role in

financing decisions because of the problems that arise be between the debt holders and the shareholders (Arwinge, 2013).

The agency cost theory arose from the seminal contributions of Jensen & Meckling (1976). Agency cost theory assumes that firm's financing structure can be used as a mechanism or vehicle by managers and investors solve the free cash flow problem. Agency theory explains that corporate form of organizations is illustrated by professional managers who have little ownership but are running business on behalf of shareholders (owners) who are extensively dispersed characterizes an archetypal principal-agent problem (Arwinge, 2013). Agency costs arises from separation of ownership and control, whereby managers maximize their own benefits or employ the firm's resources for personal gains instead of maximizing value of firm or the shareholders wealth (Mian, Haris and Muhammad, 2012).

Internal controls are among the mechanisms, which are normally used in addressing the agency problem, which affects the performance of business entities. Installation of controls is able to reduce business risks and uncertainty, which arise from information asymmetries between principals and agents (Arwinge, 2013). Agency theory affirms that systems of internal control together with other intervention mechanisms such as good financial reporting and audit can help in maintaining a cost-efficient contracting between managers and the firm owners (Düztas, 2008). The principal has to put in place some controls, which will effectively and efficiently address agency issues (Arwinge, 2013).

2.2.2 Contingency Theory

Contingency theory is usually applied in description of a relationship that exists between context and structure of effective internal control and organizational performance

especially in financial reporting perspective (Jokipii, 2010). This theory asserts that there exist no better way of design planning and system of control as well as management systems which can handle all situations effectively and successfully (Bobkova, 2014). Therefore, this theory suggests that exists no one universal control system, which is applicable to all firms in all situations.

The basic premise of contingency research is that, organizational context and structure must fit together for an organization to perform well (Jokipii, 2010). Therefore, the planning design and systems of control is dependent on various internal variables and external variables and which a better fit between both internal and external variables and management systems should result in an improved performance of an organization (Bobkova, 2014).

2.2.3 The Systems Theory

The systems theory was developed by Kaufmann (1966) to explain the historical development as a vibrant process. According to Amagoh (2008), a system consists of other subsystems whose integration and interdependence move toward an equilibrium within a larger system. Therefore, this theory is all about how systems integrate to a broad range of systems.

The systems perspective holds that to fully comprehend function of entire system, the integration among different components or individual units have to be understood. The internal control system covers all relevant areas of an entity and help in creating a properly organized and controlled unit (Cheruiyot, 2014). The theory offers powerful tools to analyze systems of internal control and to understand interactions since an effective system

of internal control is an integrated system with interrelated components, supporting principles and attributes (Ayagre, Ishmael & Nartey, 2014).

2.3 Determinants of Financial Performance

This section will examine internal controls, entrepreneur competencies, firm characteristics, availability of funds and industry competition as the determinants of performance of SMEs

2.3.1 Internal Control Practices

Internal control practices include environment control, assessment of risk, control activities, information, communication, and finally monitoring. Internal control practices enhance efficiency of operations by application of standardized procedures. Internal control practices also provide the reliability of financial reporting; assist management in making proper and good financial decisions and identification and elimination of fraudulent acts within a business entity (Uzun, 2011).

2.3.2 Entrepreneur Competencies

Entrepreneurial competencies refer to entrepreneurs' features like knowledge, attitude, skills, abilities, expertise and behavioral tendencies required for a successful and sustainable entrepreneurship (Hans, 2014).

2.3.3 Firm Characteristics

Firm characteristics are defined as firm personalities or attributes that tend to describe a firm or tell us about the firm. Three major areas, the nature of firm, firm knowledge, and

firm size, represent firm characteristics (Hans, 2014). As micro or small businesses owners are the heads of their particular enterprises, having a good understanding of the firm's nature, firm size and firm knowledge is very imperative for them to manage their firms effectively (Lucky & Minai, 2011). Nature of firm could mean type of firm (e.g. marketing firm, service, advertising firm, etc).while firm knowledge refers to the owner's adequate knowledge in terms of customers, suppliers, employees and other stakeholders of the firm in order to effectively manage the business. Firm size is defined by means small, medium or large or the sector the firm belongs to or conducts its business.

2.3.4 Availability of Funds

Funds are the blood stream of any business entity since funds determines significant part of business entity's performance (Akinruwa, Awolusi & Ibojo, 2013). Lack capital, inadequate access funding and credit facilities have been poised to influence the performance of small enterprises. Thus, SMEs cannot obtain external finance to fund expansion and improve their performance (Mahmood, 2008).

2.3.5 Industry Competition

Competitor oriented firms can identify and understand strengths and weaknesses of existing or potential rivals in a short or Striving to gain competitive advantage is the goal of competitor oriented firms. SMEs entrepreneurs are operating in a highly competitive environment

2.4 Empirical Literature Review

Morteza, Parviz and Shima (2015) assessed the existence of the relation between internal control system and performance in financial perspective of Telecommunication Company of Golestan province in Iran. The study revealed a significant and positive relation between internal control system and performance in financial perspective of the Telecommunication Company of Golestan province. Thus, the study concluded that existence of system of internal control influence financial performance positively and an internal control system seems to be necessary for effective performance.

Haat (2012) assessed the relation between internal controls on SME performance. A significant relation between implementation of internal control and SMEs performance in financial perspective. In addition, the study revealed that most of the SMEs in Malaysia were ready to implement internal controls but the concept was still in primitive stages and that most SMEs lack of awareness on the advantages of internal control to their businesses.

Mwakimasinde, Odhiambo and Byaruhanga (2014) examined effect of systems of internal control on performance in financial perspective of sugarcane out grower firms in Kenya. The study adopted a descriptive correlational survey design and collected data using questionnaires. In addition, the study used the key informant's method where is obtained data from all the finance managers and heads of internal audit for every out grower company. The data collection instrument was administered to all the nine sugarcane out grower institutions. The study findings revealed a positive significant effect of systems of internal control on performance in financial perspective.

A study by Muraleetharan (2011) assessed whether internal control system can lead to an increased performance in financial perspective of organizations. The findings of the study established that internal control and performance in financial perspective are statistically significant and a positive relation between communication and information, environment control and performance in financial perspective.

Ali (2012) examined the relationship between internal controls on SME performance. A significant relation between implementation of internal control and SMEs performance in financial perspective. In addition, the study revealed that most of the SMEs in Malaysia were ready to implement internal controls but the concept was still in primitive stages and that most SMEs lack of awareness on the advantages of internal control to their businesses.

Shamsuddin and Johari (2014) explored effect of internal auditing towards systems of internal control effectiveness in higher learning institutions in Selangor. Systems of internal control were looked from the perspectives of environment control, assessment of risk, control activities, communication and information and monitoring. The study was conducted by reviewing previous studies as research designs. The study concluded that, internal audit may influence internal control system effectiveness of higher learning institutions and it needs to be proven empirically by fieldwork study.

Byaruhanga (2014) assessed effect of systems of internal control on performance in financial perspective of sugarcane out grower firms in Kenya. The study adopted a descriptive correlational survey design and collected data using questionnaires. In addition, the study used the key informant's method where is obtained data from all the finance managers and heads of internal audit for every out grower company. The data collection

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Mugo (2013) explored the relation between systems of internal control and performance in financial perspective in Technical Training Institutions in Kenya. Data for the study was collected using questionnaires from a population of 37 technical training institutions in Kenya. The study findings revealed that management of institutions was committed to control systems and actively participated in monitoring and supervision of the activities of the technical training institutions in Kenya.

Shanmugam, Haat and Ali (2012) examined the relationship between internal controls on SME performance. A significant relation between implementation of internal control and SMEs performance in financial perspective. In addition, the study revealed that most of the SMEs in Malaysia were ready to implement internal controls but the concept was still in primitive stages and that most SMEs lack of awareness on the advantages of internal control to their businesses.

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2.5 Conceptual Framework

Conceptual framework diagrammatically depicts the relation between dependent and the independent variables of a study. Dependent variable for this study was performance in financial perspective while independent variables will include environment control, assessment of risk, control activities, communication and information and finally monitoring. Figure 2.1 depicts the conceptual framework

Independent Variables   **Dependent Variable**

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┌─────────────────────────────────┐
│      Environment control        │
│  • Control policies, procedures │
│    and methods                  │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│      Assessment of risk         │
│  • Risk identification and      │
│    analysis                     │                    ┌─────────────────────────┐
└─────────────────────────────────┘                    │  Financial Performance  │
                                                        │         (ROA)           │
┌─────────────────────────────────┐                    └─────────────────────────┘
│      Control activities         │
│  • Segregation of duties and    │
│    limits                       │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│  Communication and information  │
│  • Identification, capture and  │
│    exchange of information      │
└─────────────────────────────────┘

┌─────────────────────────────────┐
│         Monitoring              │
│  • Self-assessments, peer       │
│    reviews and internal audits  │
└─────────────────────────────────┘
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Figure 2.1 Conceptual Framework

2.6 Summary of Literature Review

From reviewed studies have emphasized that effective internal control play a critical role in a firm's success and performance. However, it is evident that most studies on internal control around the globe and in Kenya; for instance Morteza et al. (2015), Weili et al (2014), Gyebi and Quain (2013), Mwakimasinde et al. (2014) and Mugo (2013) have concentrated large and well established firms compared to small and medium enterprises. Thus, the studies on internal control practices on the performance of SMEs remain

relatively unexplored by researchers and the lack of the studies creates a new research need and opportunity in order to provide an adequate picture of effect of internal control practices on performance in financial perspective of SMEs.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

Chapter three focuses on study research design, study population, the sample design, collection of data techniques and techniques of analysis

3.2 Research Design

A research design refers to plan which guide a researcher on how to organize the research activities (Bryman & Bell 2003). A research design presents a framework or arrangement of action for a study. A descriptive research design was adopted in this study. A descriptive research defines or explains a subject by creating a pool of events, people and problems through data collection

3.3 Population of the Study

Population refers to a set of people or items with similar characteristics which a researcher intends to study and to draw statistical inferences or conclusions (Gall et al., 2006. Population of this study comprised of all the small and medium enterprises in Nairobi County, which have less than 50 employees and a turnover of less than Kes. 50 million. According to Nairobi City County Licensing Records (2016), there are over 85000 registered SMEs within Nairobi County.

3.4 Sample Design

A sample is a selected group from the targeted population on which information is obtained. Thus, using simple random sampling technique a sample of 100 SMEs was randomly selected. The sample was determined using Yamane (1967) formula as follows;

$$n = \frac{N}{1 + N(e^2)} \text{ Thus; } n = \frac{85000}{1 + 85000(0.1^2)} = 99.88 = 100$$

Where; n = Sample size, N = Population & e = Significance level (0.1)

3.5 Data Collection

Both primary and secondary data as used, which was collected using self-administered questionnaires to the sampled respondents who comprised of the SMEs owners or managers/employees. The questionnaire was designed such that the respondents could easily comprehend the questions there in. Secondary data on financial performance of the SMEs was collected from the SMEs financial statements.

3.6 Validity and Reliability

Validity of the research instruments will be determined using expert opinions and other professionals who are conversant with the study topic where their opinions will be evaluated and incorporated where possible. Reliability of the study instrument was established using Cronbach (α) Alpha Coefficient. The coefficient alpha coefficient is the most commonly applied estimate of a multiple-item scale's reliability and an alpha value of 0.7 or more is recommended.

3.7 Data Analysis

The data was sorted, corded and the summarized using descriptive statistics like the mean and standard deviation and thereafter-inferential statistics was used to arrive at or draw conclusions.

3.7.1 Analytical Model

To establish relation between internal control practices and performance of SMEs the multiple linear regression was employed. The regression model was derived from the equation of a straight line, which resulted in the following equation;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon$$

Where;

Y = Performance of SMEs measured using a likert scales

X_1 = Environment control measured using a likert scales

X_2 = Assessment of risk measured using a likert scales

X_3 = Control activities measured using a likert scales

X_4 = Communication and information measured using a likert scales

X_5 = Monitoring measured using a likert scales

β_0 = Constant

$\beta_1 - \beta_5$ = Regression Coefficients

ε = Error tem

3.7.2 Test of Significance

The study used the F and t-test statistic to measure statistical significance. F test was used to establish statistical significance of regression equation while t-test was used to test significance of regression coefficients at 0.005 level of significance.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND INTERPRETATION

4.1 Introduction

Chapter four outlines results of the research findings. The chapter presents the response rate, the data reliability, descriptive statistics, regression analysis and the interpretation of the findings.

4.2 Response Rate

This study used a sample of 100 SMEs in Nairobi County. Out of the 100 questionnaires issued only 73 were responded to thus a response rate of 73%, which was considered sufficient.

4.3 Data Reliability

Table 4.1 Data Reliability

	Cronbach's Alpha	N of Items
Environment control	.784	5
Assessment of risk	.717	5
Control activities	.737	5
Communication and information	.890	5
Monitoring	.761	5

Source: Research Findings

Table 4.1 shows the results of data reliability using the Cronbach alpha coefficient. The results indicate that all the Cronbach alpha coefficients are above the recommended 0.7 alpha coefficient. This indicates that the questionnaire is reliable.

4.4 Descriptive Statistics

This section provides the descriptive statistics on the study variables which includes the environment control, assessment of risk, controls activities, communication and information and monitoring.

4.4.1 Environment control

Table 4.2 Environment control

	Mean	Std. Deviation
Does environment control reflect the attitude and the policies of management and it's an important auditing function	1.82	.788
Does environment control set the tone of an organization and influence the control consciousness of its people	1.77	.755
Does the environment control affect the entire organization and all other elements of internal controls	2.00	.850
Does the environment control assist toward reducing the level fraudulent activities within organizational operation	1.97	.833
Does the quality of an entity's systems of internal controls depend on function and quality of their environment control	1.97	.986

Source: Research Findings

The results on table 4.2 indicate that the highest mean value is 2.00, which indicates that the respondents agree that the environment control affect the entire organization and all other elements of internal controls. The other mean values are 1.97, which indicate that the respondent strongly agreed that the environment control assist toward reducing the level fraudulent activities within organizational operation and the quality of an entity's internal controls system depend on the function and quality of their environment control. The least mean point are 1.82 and 1.77 which indicates that the respondents strongly agree that environment control reflect the attitude and the policies of management and it's an important auditing function and environment control sets the tone of an organization and influence the control consciousness of its people.

4.4.2 Assessment of risk

Table 4.3 Assessment of risk

	Mean	Std. Deviation
Does assessment of risk involve the identification and analysis of relevant risks facing the business	2.05	.864
Does the assessment of risk determine any situation that may pose legal or financial risk to the firm	1.82	.822
Does assessment of risk help to maintain business risks within determined the required risk level.	2.04	.920
Does assessment of risk integrate professional judgment about probable adverse conditions and the likelihood of possible losses?	2.00	.957
Does assessment of risk help the management to form a basis of the risks facing the business to be managed?	1.73	.786

Source: Research Findings

Table 4.3 indicates that the highest mean values are 2.05 and 2.04, which indicates that the respondents agreed that assessment of risk involve the identification, and analysis of relevant risks facing the business and assessment of risk helps to maintain business risks within determined the required risk level. The results also indicate a mean value of 2.0, which means that the respondents agreed that assessment of risk integrates professional judgment about probable adverse conditions and the likelihood of possible losses. The results also indicate that the least mean values are 1.82 and 1.73, which means that the respondents strongly agreed that assessment of risk determines any situation that may pose legal or financial risk to the firm and assessment of risk help the management to form a basis of the risks facing the business to be managed.

4.4.3 Control Activities

Table 4.4 Control Activities

	Mean	Std. Deviation
Do control activities entail the policies and procedures that ensure management directives are carried out properly?	1.75	.813
Do control activities ensure that necessary actions are taken to address risks to achievement of the entity's objectives?	1.99	.842
Do control activities describes the policies, procedures and best practices a small business can put in place to minimize risk?	2.03	.881
Do control activities help to address risks to achieve business objectives?	1.89	.809
Should control activities be implemented thoughtfully, conscientiously, and consistently for them to be useful?	1.97	.781

Source: Research Findings

The findings on table 4.4 indicates that the highest mean value was 2.03 which means that the respondents agreed that control activities describes the policies, procedures and best practices a small business can put in place to minimize risk. The results also show mean values of 1.99 and 1.97, which indicates that the respondents strongly agreed that control activities ensure that necessary actions are taken to address risks to achievement of the entity's objectives, and that control activities should be implemented thoughtfully, conscientiously, and consistently for them to be useful. Finally, the results show that the least mean values are 1.89 and 1.75, which means that control activities help to address risks to achieve business objectives and control activities entails the policies and procedures that ensure management directives are carried out properly.

4.4.4 Communication and information

Table 4.5 Communication and information

	Mean	Std. Deviation
Does communication and information-systems enable people in the organization to carry out their responsibilities	2.05	.926
Is information is the vehicle by which control policies, procedures are introduced and reinforced	1.97	1.000
Does communication enable employees to become aware of management's commitment to internal controls	1.96	.934
Should information be communicated throughout the entire organization to permit personnel to carry out their responsibilities	1.95	.880
Does reliable and relevant information from both internal and external sources should be communicated to everyone in the organization	1.89	.809

Source: Research Findings

The findings on table 4.5 indicates that the highest mean value is 2.05 and 1.97 which indicates that the respondents agreed and strongly agreed that communication and information-systems enable people in the organization to carry out their responsibilities and information is the vehicle by which control policies, procedures are introduced and reinforced. The results also show mean values of 1.96 and 1.95, which means that the respondents agreed that communication enable employees to become aware of management's commitment to internal controls and information should be communicated throughout the firm to permit personnel to carry out their responsibilities. The least mean values is 1.89 which means that the respondents strongly agreed that reliable and relevant information from both internal sources and external sources should be communicated to everyone in the organization.

4.4.5 Monitoring

Table 4.6 Monitoring

	Mean	Std. Deviation
Is monitoring accomplished by ongoing monitoring activities and by separate evaluations of intern controls	1.99	.935
Does monitoring describe a small business' practices of self-auditing its risk management systems	2.10	.930
Does monitoring help in ensuring that all employees are compliant with the internal policies of the business	2.11	.921
Does monitoring determine whether internal control is adequately designed, properly executed and effective	1.97	.849
Does monitoring provide assurance that the findings of audits and other reviews are promptly determined	2.12	.897

Source: Research Findings

The results on table 4.6 indicates that the highest mean values are 2.12 and 2.11 which means that the respondents agreed that monitoring provide assurance that the findings of audits and other reviews are promptly determined and that monitoring help in ensuring that all employees are compliant with the internal policies of the business. The results also show mean values of 2.10 and 1.99, which means that the respondents agreed monitoring describe a small business' practices of self-auditing its risk management systems and that the respondents strongly agreed that monitoring accomplished by ongoing monitoring activities and by separate evaluations of intern controls. The results further shows that the least mean value is 1.97 which indicates that the respondents strongly agree that monitoring determines whether internal control is adequately designed, properly executed and effective.

4.5 Inferential Statistics

4.5.1 Correlation Analysis

Table 4.7 shows the correlation analysis results

Table 4.7 Correlation Matrix

	Performance	Control environment	Risk assessment	Control activities	Information and communication	Monitoring
Performance	1					
Control environment	-.154	1				
Risk assessment	-.258*	.107	1			
Control activities	.316**	-.128	-.004	1		
Information and communication	.213	.335**	-.096	.137	1	
Monitoring	.175	-.058	-.059	-.024	-.062	1

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

The results on table 4.7 shows a negative correlation between control environment and risk assessment while there is a positive correlation between control activities, information and communication and monitoring.

4.5.2 Regression Analysis

4.5.1 Model Summary

Table 4.8 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.457[a]	.209	.150	.97288

a. Predictors: (Constant), Monitoring, Assessment of risk, Environment control,

Communication and information, Control activities

Source: Research Findings

The model summary results indicate that the R-square value is 0.209, which means that the

independent variables explain 20.9% of the variation in the dependent variable. The other

79.2% is explained by other factors outside the model and the error term.

4.5.2 ANOVA

Table 4.9 ANOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	16.766	5	3.353	3.543	.007[b]
	Residual	63.415	67	.946		
	Total	80.181	72			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Monitoring, Assessment of risk, Environment control,

Communication and information, Control activities

Source: Research findings

Table 4.9 indicates that the regression equation is significant to explore the relationship between internal control practices and financial performance of SMEs in Nairobi County since the p-value (0.007 < 0.05) at 95% confidence level.

4.5.3 Regression Coefficients

Table 4.10 Regression Coefficients

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.004	1.098		1.825	.072
	Control environment	-.449	.177	-.190	-2.536	.011
	Risk assessment	-.288	.303	-.103	-.950	.345
	Control activities	.617	.267	.258	2.311	.024
	Information and communication	.605	.283	.251	2.137	.036
	Monitoring	.461	.268	.187	1.718	.090

a. Dependent Variable: Financial Performance

Source: Research findings

The results on table 4.10 shows that the control environment has a negative significant relationship with financial performance of small and medium enterprises while risk assessment has negative but insignificant relationship with financial performance of small and medium enterprises. The results also show that there is a significant positive

relationship between control activities and information and communication but an insignificant positive relationship between monitoring and financial performance financial performance of SMEs in Nairobi County. From the results, the following regression equation was generated

$$Y = 2.004 - 0.449X_1 - 0.288X_2 + 0.617X_3 + 0.605X_4 + 0.461X_5 + \varepsilon$$

4.6 Interpretation of the Findings

This study found a negative relationship between control environment and risk assessment and financial performance of SMEs in Nairobi County. This indicates an inverse relationship between financial performance and control environment and risk assessment of SMEs in Nairobi County hence an indication that the failure to assess the control environment and to carry a proper risk assessment procedure will lead to a reduction in SMEs financial performance.

The results also found a positive relationship between control activities, information and communication and monitoring. This indicates that there is a direct relationship between control activities, information and communication and monitoring and financial performance of SMEs in Nairobi County. The results also indicate that the application of control activities, sharing of information, communicating the information, and monitoring positively affects SMEs financial performance.

A study by Morteza, Parviz and Shima (2015) concluded that existence of system of internal control influences performance in financial perspective positively and an internal control system seems to be necessary for effective performance. Mwakimasinde, Odhiambo and Byaruhanga (2014) revealed a positive significant effect of internal control

system on the financial performance. Nyakundi, Nyamita and Tinega (2014) established that systems of internal control significantly influence performance in financial perspective.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Chapter five presents the summary of findings of this research, conclusions, recommendations, limitations of the study and suggestion of areas which may require further consideration as far as future research is concerned.

5.2 Summary

This study examined effects of internal control practices on performance in financial perspective of SMEs in Nairobi County. The study explored the agency theory, the contingency theory and the systems theory as the main theories for the research. The dependent variable for this study was performance in financial perspective while the independent variables included environment control, assessment of risk, control activities, communication and information and finally monitoring. This study used a sample of 100 SMEs in Nairobi County and out of the 100 questionnaires issued only 73 were responded to thus a response rate of 73%.

The descriptive results established that there was general agreement among the respondents that environment control, assessment of risk, control activities, communication and information and monitoring influence have an impact on the operation of SMEs. The correlation results revealed a negative correlation between control environment and risk assessment while there is a positive correlation between control activities, information and communication and monitoring.

The model summary established that independent variables explained 20.9% of the variation in the dependent variable. The results also established that the regression model was significant to explain the relationship between internal control and financial performance of SMEs in Nairobi County. The regression coefficient results established that the control environment and risk assessment had a negative relationship with financial performance of small and medium enterprises. The results also revealed a positive relationship between control activities and information and communication and monitoring and financial performance financial performance of SMEs in Nairobi County.

5.3 Conclusion

The findings of the study found a negative relationship between control environment and risk assessment and financial performance of SMEs in Nairobi County. The study thus concludes that there is an inverse relationship between financial performance of SMEs in Nairobi County and the control environment and risk assessment.

The study findings also revealed a positive relationship between control activities, information and communication, monitoring and the financial performance of SMEs in Nairobi County. This study concludes that there is a direct relationship between control activities, information and communication, monitoring and the financial performance of SMEs in Nairobi County.

5.4 Recommendation of the Study

The study concluded that control activities, information and communication, monitoring had a direct relation with performance in financial perspective of SMEs in Nairobi County. Thus, the study recommends that SMEs should ensure there they have effective control

activities, efficient information and communication methods and proper monitoring strategies.

The study also concluded an inverse relationship between the control environment, risk assessment and the financial performance of SMEs in Nairobi County. Thus, the study recommends that SMEs in Nairobi County should ensure that they establish an effective control environment and proper risk assessment policies to ensure that their internal controls are effective and to enhance their financial performance.

5.5 Limitations of the Study

This study focused on internal control practices and performance in financial perspective of SMEs in Nairobi County. Thus, the study findings are based on SMEs and the findings may not be applicable to larger organization with well established organization which has well instituted internal control practices.

Primary data was collected using questionnaire and data on secondary on performance in financial perspective of SMEs was obtained using a data collection form for a period of 2 years. However, most SMEs do not keep accurate data on financial performance hence the reliability and validity of the secondary data could not be established.

5.6 Suggestion for Further Research

The study recommends that an analysis of factors that influence adoption of internal control practices by SMEs in Nairobi county. The study also suggests an examination of the effectiveness of systems of internal control adopted by SMEs in Nairobi County.

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APPENDICES

Appendix I: Questionnaire

Dear Respondent,

The aim of this questionnaire is to obtain data on the effects of internal control practices on the performance of small and medium enterprises (SMEs) in Nairobi County. This study is for academic purposes and any information provided will be used for academic purposes and will be treated confidential. Your support and cooperation will be highly appreciated.

Section I: Background Data

1. Please indicate your position

   Owner   [   ]   Employee   [   ]

Section II: Environment control

2. Please evaluate the following statements on environment control as an internal control practice. Use the following scale where appropriate

   1-Strongly agree   2- Agree   3 – Neutral   4- Disagree   5- Strongly Disagree

Statement	1	2	3	4	5
Does environment control reflect the attitude and the policies of management and it's an important auditing function					
Does environment control set the tone of an organization and influence the control consciousness of its people					

Does the environment control affect the entire organization and all other elements of internal controls					
Does the environment control assist toward reducing the level fraudulent activities within organizational operation					
Does the quality of an entity's internal controls system depend on the function and quality of their environment control					

Section III: Assessment of risk

3. Please evaluate the following statements on assessment of risk as an internal control practice. Use the following scale where appropriate

   1-Strongly agree   2- Agree   3 – Neutral   4- Disagree   5- Strongly Disagree

Statement	1	2	3	4	5
Does assessment of risk involve the identification and analysis of relevant risks facing the business					
Does the assessment of risk determine any situation that may pose legal or financial risk to the firm					
Does assessment of risk help to maintain business risks within determined the required risk level.					
Does assessment of risk integrate professional judgment about probable adverse conditions and the likelihood of possible losses?					
Does assessment of risk help the management to form a basis of the risks facing the business to be managed?					

Section IV: Control activities

4. Please evaluate the following statements on control activities as an internal control practice. Use the following scale where appropriate

1-Strongly agree   2- Agree   3 – Neutral   4- Disagree   5- Strongly Disagree

Statement	1	2	3	4	5
Do control activities entail the policies and procedures that ensure management directives are carried out properly?					
Do control activities ensure that necessary actions are taken to address risks to achievement of the entity's objectives?					
Do control activities describes the policies, procedures and best practices a small business can put in place to minimize risk?					
Do control activities help to address risks to achieve business objectives?					
Should control activities be implemented thoughtfully, conscientiously, and consistently for them to be useful?					

Section V: Communication and information

5. Please evaluate the following statements on icommunication and information as an internal control practice. Use the following scale where appropriate

1-Strongly agree   2- Agree   3 – Neutral   4- Disagree   5- Strongly Disagree

Statement	1	2	3	4	5

Does communication and information-systems enable people in the organization to carry out their responsibilities					
Is information is the vehicle by which control policies, procedures are introduced and reinforced					
Does communication enable employees to become aware of management's commitment to internal controls					
Should information be communicated throughout the entire organization to permit personnel to carry out their responsibilities					
Does reliable and relevant information from both internal and external sources should be communicated to ever one in the organization					

Section VI: Monitoring

6. Please evaluate the following statements on monitoring as an internal control practice.

   Use the following scale where appropriate

   1-Strongly agree   2- Agree   3 – Neutral   4- Disagree   5- Strongly Disagree

Statement	1	2	3	4	5
Is monitoring accomplished by ongoing monitoring activities and by separate evaluations of intern controls					
Does monitoring describe a small business' practices of self-auditing its risk management systems					

Does monitoring help in ensuring that all employees are compliant with the internal policies of the business					
Does monitoring determine whether internal control is adequately designed, properly executed and effective					
Does monitoring provide assurance that the findings of audits and other reviews are promptly determined					

Section VII: Performance

7. Please indicate the values in the columns below as at the End of the year indicated

Statement	2014	2015
Net profit		
Total assets		

Thank you