

Factors Contributing to the Existence of Undetected Fraud Within Retail SMEs in the Cape Metropole

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Abstract:

Small and medium-sized enterprises (SMEs) are expected to play a key role within a country's gross domestic product (GDP), economic growth, and job creation. In South Africa, the economic value of SMEs is recognized and supported by the government. However, these smaller entities often have limited internal resources and consequently have a more vulnerable business environment. One such threat is fraud that is committed against these businesses. The focus on the prevention and control of fraud generally tends to be on larger organizations, and research examining fraud within SMEs is limited. This study investigates the factors that may contribute to the existence of undetected fraud within small retail lending to these entities. The study followed a quantitative research methodology classified as survey research as it used a questionnaire to collect and process large amounts of data. The results of this survey indicate that there is a lack of expertise or knowledge, and inadequacy of prioritizing fraud detection by these business owners which could be contributing to a high percentage of undetected fraud within the retail SMEs population. The findings of this study reinforce prior literature highlighting the resource limitation and informal strategies often employed by retail SMEs in managing fraud risks.

Keywords:

Retail SMEs, Fraud Detection, Cape Metropole, Internal Controls, Risk Management, GDP

Submitted: 2024-08-19. Revised: 2024-12-30. Accepted: 2025-01-06.

Introduction

Small and medium-sized Enterprises (SMEs) are regarded undoubtedly as vital role players in economies of most developing and emerging countries, such as South Africa (Mutezo; 2013). Their contributions to the economic development are significant in the areas of job creation, enhancement of growth, and poverty alleviation (Mutezo, 2015). A recent study conducted by Yusoff, Wahab, et al. (2018) similarly opined that these business entities contribute significantly in the stimulation of the economy. SMEs contribute in terms of not only alleviating poverty but also contributing a favourable GDP output (Dubihlela & Qeke, 2018).

Despite the fact that SMEs have contributed positively on the economic development, specifically in South Africa, these business entities are affected by fraud more heavily due to inadequate fraud risk management as well as weak internal control systems (Thomas & Gibson, 2003; Bierstaker, Brody & Pacini, 2006). Bressler and Bressler (2007) support this view by noting that fraud accounted for 30% of small business failure in the 1990s. Smaller companies often feel that they are less likely to be a target of fraudsters (CIMA, 2009, CIMA, 2020). The Association for Certified Fraud Examiners' (ACFE) report (ACFE, 2018) added to other researchers' views by indicating that small entities suffer from fraud more often than large companies. ACFE (2018) further opined that when smaller enterprises are faced with fraud damages, it is usually difficult for them to be able to engross the loss as compared to larger enterprises, thus leading them to the risk of going out of business as a result. Moreover, Hanno & Hughes (1999) also have shown that small entities are more likely to be susceptible to fraud than larger firms. This is owing to the absence of resources and their inability to implement adequate internal control mechanism to mitigate fraud risks (Ezeonwuka & Dubihlela, 2018). It is vitally important that SMEs in South Africa have management consultations on their staff or to outsource the services of specialists in internal control and risk management.

Literature Review

Economic Importance of SMEs in South Africa

Research has consistently shown that Small and Medium-sized Enterprises (SMEs) play a crucial role in driving economic growth, job creation, and innovation in developing countries. In South Africa, SMEs contribute significantly to the Gross Domestic Product (GDP) and employment rates, making them a vital component of the nation's economic landscape. Mutoko (2017) suggested that small firms contributed positively to the economy in the sense that they provide a source of livelihood and employment for many. In support to the notion, Prinsloo et al (2015) reiterated that SMEs are significant and important to the economy, especially in developing countries due to the important role, they play in job creation. Statistically, in South Africa, SMEs contribute up to 80% to all local employment

opportunities and further massively contribute to the GDP in the range of 30% to 57%, thus it suffice to state and hold that SMEs are critical to the economy at large.

Vulnerability of SMEs to Fraud

Prior studies have indicated that smaller businesses are often more susceptible to fraud due to limited resources, less sophisticated internal control systems, and a higher degree of trust placed in employees. The Association of Certified Fraud Examiners (ACFE) (2018) reports that SMEs suffer disproportionately higher losses from fraud compared to larger organizations. Undetected fraud refers fraudulent activities or schemes that have not been identified or caught by the usual detection methods or internal controls within a system or organisation (Wells, 2022).

Types of Fraud Common in Retail SMEs

Literature identifies various forms of fraud prevalent in retail SMEs, including employee theft, inventory shrinkage, cash skimming, and financial statement fraud. These fraudulent activities can have severe consequences on the financial health and sustainability of small businesses.

The control measures that are employed to address the risk of fraud are generally grouped into three controls towards achieving its objectives, as explained below.

Fraud prevention control

Fraud prevention control is the first stage depicted in the fraud risk management framework; it requires the introduction of appropriate strategies that can prevent fraud risk within an entity (Hussaini et al., 2018). Fraud prevention control is aimed at mitigating the risk of fraud from occurring by having an anti-fraud programme, employees background checks, fraud awareness training, system edit checks, matching of data for eligibility, proactive analytics, rules of conduct, segregation of duties, and transactions limits (GAO, 2015, Deloitte, 2023).

Based on prior examination of why individuals commit fraud, it appears that one of the most successful approaches to combat the problem of fraud is to employ tactics that reduce motive, limit opportunity, and limit the capacity of potential fraudsters to rationalise their actions (Albrecht, W. S., Albrecht, C. C., & Albrecht, C. O., 2020). The goal of preventative measures in the case of purposeful acts of fraud is to decrease opportunity and eliminate temptation from potential perpetrators. To prevent fraud, prevention tactics include the implementation of rules, processes and controls, as well as activities such as training and fraud awareness. It is prudent to prevent losses, and fraud prevention operations can help maintain a company's stability and continuous existence (CIMA, 2020).

According to recent polls, however, many organisations do not have a structured approach to fraud prevention. Once a scam has happened, the chances of retrieving stolen monies from the criminal or

through insurance are frequently slim. Based on the prior examination of why individuals commit fraud, it appears that one of the most successful approaches towards combatting the problem of fraud is to employ tactics that reduce motive, limit opportunity, and limit the capacity of potential fraudsters to rationalise their actions (CIMA, 2020).

Fraud detection control

Fraud detection entails policies and procedures designed to detect fraud before and after the occurrence (Hussaini et al., 2018). Fraud detection control is intended to enable the organisation to quickly and efficiently detect fraudulent activities that may have side stepped the preventive control, thus enabling the organisation to take corrective action (Hussaini et al., 2018). To effectively detect fraudulent activities, management should ensure that there is an auditing team, matching of data after a transaction, data mining, and having a fraud hotline in place to report all possible fraud activities (GAO, 2015). Because fraud prevention strategies may not deter all prospective criminals, organisations should ensure that procedures are in place to detect and report fraud in a timely way. This is accomplished by the identification of fraud.

According to CIMA (2020), a plan to detect fraud must include the application of analytics and other relevant techniques that recognise and uncover anomalies. The plan should furthermore implement reporting lines and channels that enable the communication of suspected fraudulent activities (CIMA, 2020). Fraud detection may bring to light ongoing fraud or offenses that have already occurred. Such schemes may be unaffected by the implementation of preventive tactics, and even if the fraudsters are thwarted in the future, the only way to recoup prior losses is through fraud detection. However, the potential recovery of losses is not the main goal of a detection programme, and fraudulent behaviour should not be overlooked just because there may be no recovery of losses. The identification of fraud also enables the enhancement of internal systems and controls (CIMA, 2020).

Challenges in Fraud Detection for SMEs

Research highlights that SMEs face unique challenges in detecting and preventing fraud. These include limited financial resources for implementing robust control systems, lack of segregation of duties due to smaller staff sizes, and insufficient expertise in fraud detection techniques.

The role of internal controls in fraud prevention: Studies emphasize the importance of internal controls in mitigating fraud risks. However, research also indicates that many SMEs struggle to implement and maintain effective control measures due to resource constraints and lack of awareness.

Methods and Data

The study employs a quantitative approach to investigate factors contributing to undetected fraud in retail SMEs within the Cape Metropole. This research is limited to small retail enterprises that operate in Cape Metropole. Only responses from retail business owners and staff members in managerial position of clothing stores, supermarkets, convenience stores, mobile stores and street traders were taken into consideration, since they are deemed to be knowledgeable about fraud risks affecting their businesses. For the sake of clarity, delineation criteria for this study were set as follows:

- All respondents should be retail business owners and staff members in the managerial position in their respective entities.
- All respondents should be operational small retail business trading entities
- All responses should be from those SMEs involved in the buying and selling of goods and services.
- All respondents must employ between five and two hundred and fifty employees
- All respondents should be from the SMEs that hold a turnover to the maximum of R80 million.

Data Collection Method

A structured questionnaire was distributed to a sample of 150 retail SME owners and managers in the Cape Metropole and 105 participated landing at 70% yield return. The survey aimed to gather data on fraud awareness, existing control measures, and perceived challenges in fraud detection.

Results

Quantitative data were analyzed using descriptive and inferential statistics. The results were represented as follows:

Type of retail store	35% operated as Supermarket 17% were Convenient Stores 13% operated as Specialty Stores 17% were Departmental Stores 17% operated in E-Commerce
Number of years store has been in existence	49% were in operation for a range of 1-10 years 26% were in operation for a range of 11-20 years

	18% were in operation for a range of 21-30 years 8% were in operation for a range of 31-40 Years
Number of employees hired by the retail stores	57% employed between 1 -10 employees 29% employed between 11-20 employees 10% employed between 21-30 employees 2% employed between 31-40 employees 3% employed 41-50 employees
Position Respondents held in the organisation	90.5% held managerial positions 9.5% were owners
Sampled SMEs Business Location	18% were located in Tableview 34% were located at Century City 15% were located in Cape Town City Centre 11% were located in Table Bay 10% were located in Sea Point 10% were located in Green Point

Table 1: Demographic Summary of Sampled SMEs (Source: Own source)

Type of retail store: Most of the respondents were operating in Supermarket retail stores that contributed 35% of the respondents, meanwhile 51% of the respondents were from Convenient Stores, Departmental Stores and E-commerce. There was a low variability of the data as the standard deviation of the data set was 0.09 which avail that the data set was clustered around the mean which stood at 20%. Thus there was a fair distribution of the stores that were sampled. Regarding the make-up of our respondents, 90.5% held managerial position whilst only 9.5% were owners.

Furthermore, 18% of the sampled respondents from SMEs stores were located in Tableview, whilst the majority of the SMEs were situated in Century City, that constituted 34% and minimal number of them were located in Green Point and Sea Point and these contributed 10% of the sampled stores.

Statement (factors leading to undetected fraud)	Strongly agree	Agree	Neither agree nordisagree	Disagree	Strongly disagree
Absence of anti-fraud	19%	33%	20%	15%	13%
Lack of fraud prevention policy	25%	39%	17%	10%	10%
Inadequate internal controls	23%	36%	18%	11%	12%

Table 2: Summary of perceived factors causing undetected fraud in SMEs
(Source: Own source)

The majority of the respondents, 35(33%) agreed to the assertion followed by 19(18%), who strongly agreed that lack of anti-fraud programs in an organisation result in undetected fraud. Minimum number of respondents, whilst 21(20%) were neutral about the assertion. On the other hand, 16(15%) of the respondents disagreed to the prompt and 14(13%) strongly disagreed to the assertion.

Regarding lack of prevention policy as a factor to the vulnerability of SMEs to undetected fraud, 41(39%) agreed to the assertion that lack of fraud detection policy in an organisation results in undetected fraud, and 26(25%) strongly supported the assertion. An equal distribution of respondents was established, when 10(10%) strongly disagreed, 11(10%) disagreed and 17(17%) were neutral to the assertion that absence of fraud detection policy within SMEs was one of the major factors contributing to the occurrence of undetected fraud.

The research results present that most of respondents, 37(36%) agreed to the assertion that inadequate internal control systems lead to undetected fraud, whilst 24(23%) strongly agreed to the assertion. Thirteen (12%) strongly disagreed whilst 11% of the responded disagreed to the assertion. Furthermore, 19(18%) of the respondents were neutral or undecided about the prompt. Therefore, it is conclusive that a number of factors including inadequate internal controls, absence of undetected fraud prevention policy, absence of fraud detection tools and poor communication within SMEs play a pivotal role as causatives to the susceptibility of SMEs to undetected fraud.

Responsive Control

Responsive control includes corrective measures taken by management as remedy for the undesired outcome caused by fraud. Notably, fraud response measures affect the occurrence of fraud within the retail enterprise, therefore, the stronger the fraud response measures, the less the likelihood of fraud. According to KPMG (2016), fraud occurrence, depending on the extent, may negatively affect the survival of an organisation. It is therefore a prerequisite for an organisation to design, implement and maintain fraud risk management periodically (COSO, 2016).

Discussion

The background to the research led to the notion that managers and owners of small retail enterprises operating in Cape Town (delimited to Century City, Table View, Sea Point, Green Point, Table Bay and Cape Town City Centre) do not make use of risk management frameworks to control the risk of fraud within their organisation, and this has resulted in financial losses through fraudulent activities. This perception was as articulated in the literature review as follows:

- SME retail stores are affected by a plethora of fraud risk classes categorised as corruption, asset misappropriation and financial statement fraud (ACFE, 2020).
- Fraud risk is high in the SME retail sector, which can be attributed to a lack of segregation of duties and undefined policies and procedures; furthermore, the risk emanates both internally and external to the organisation (Smith, 2022:293-307).
- Most SME retail stores incur huge financial losses due to fraud because of a lack of commitment in terms of prioritising risk management and fraud risk management controls within the organisation (Myemane, 2019).
- Negating the implementation of the enterprise risk management approach and relying on traditional risk management methods have limited SME retail stores' capacity to detect fraud timeously, resulting in unprecedented losses crippling most firms (McKinsey, 2018).

Fundamentally, most retail stores in Cape Town (delimited to the selected research locations) do not implement risk management frameworks in their organisation, and this has resulted in financial and material losses. It is therefore imperative that these organisations develop and continuously apply fraud risk management controls and frameworks to minimise and deter losses.

Conclusion

Limitations and Recommendations

The study focuses specifically on retail SMEs in the Cape Metropole, which may limit the findings to other sectors or regions. In addition, the reliance on self-reported data may introduce potential bias in the responses. The study does not directly measure actual fraud occurrences but rather focuses on perceptions and reported challenges. A couple of recommendations were made to the owners and managers of small retail SMEs to develop targeted fraud awareness and prevention training programs for retail SME owners and employees.

It is imperative to encourage collaboration between SMEs, local business associations, and law enforcement to share best practices and resources for fraud detection. Furthermore it is essentially vital

to advocate for government initiatives to provide financial and technical support to SMEs for implementing fraud prevention measures. It is recommended that SMEs undertake further research to quantify the economic impact of undetected fraud on retail SMEs in the region and to put in place fundamental fraud risk management approaches.

Outlook and Further Research

The study reveals several key factors contributing to the existence of undetected fraud within retail SMEs in the Cape Metropole. Lack of expertise and knowledge was one of the main factors leading to undetected fraud within SMEs. Many SME owners and managers lack the specialized knowledge required to implement effective fraud detection and prevention strategies. In addition, limited prioritization of fraud detection owing to competing priorities and limited resource, fraud detection is often overlooked in comparison to other business operations. This is further exacerbated by inadequate internal controls. The absence of robust internal control systems creates opportunities for fraudulent activities to go unnoticed.

It goes without saying that, the trust-based culture of managing operations in SMEs contributes largely to the occurrence of fraud. The traditional nature of operation management in SMEs can lead to an over dependence on trust, potentially blinding owners to potential red flags of fraud and negating the necessity of internal controls and operational management to minimize the occurrence of fraud within the organisations. Moreso resource constraints aggravate the susceptibility of SMEs to undetected fraud limited financial and human resources thwart the implementation of sophisticated fraud detection technologies and processes.

These findings suggest the need for targeted interventions to support retail SMEs in enhancing their fraud detection capabilities and capacities. The SMEs need to find methods to address these factors, and working towards creating a more resilient business environment for SMEs in the Cape Metropole, ultimately contributing to their long-term success, profitability and economic impact.

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