2018 Southern African Accounting Association (SAAA)
National Teaching and Learning and Regional Conference Proceedings

ISBN number: 978-0-6399544-0-0

WC001: Do Perceived Internal Control Activities Decrease the Reasonable Assurance of Business Existence of South African SMMEs?

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Abstract

In South Africa, Small, Medium and Micro Enterprises (SMMEs) are of vital importance to the national economy. The latter holds truth since these business entities add socio-economic value to South Africa through inter alia the creation of employment opportunities, the diminishing of poverty, and the distribution of wealth. Despite the positive contributions to the national economy, it was found that South African SMMEs are believed to have a failure of approximately 75% of business entities that fail after being in operation for less than four years, which are regarded to be among the worst in the world;. Previous studies suggest that this phenomenon is exacerbated by the realisation of risks which stem from unmanaged economic factors and a non-conducive economic environment. Although the damage of realised risks can be reasonably mitigated through the implementation of internal control activities, prior research shows that the implemented internal control activities within South African SMMEs are customised in nature as they are regarded as inadequate and/or ineffective in their approach to mitigate risks. As such, this study places emphasis on establishing whether implemented internal control in South African SMMEs, as perceived by management, decreased the reasonable assurance surrounding the existence of these business entities, in the foreseeable future. Through survey research, primary quantitative data were collected from 119 members of management of South African SMMEs. From the results, it was concluded that the perceived internal control activities evident in these business entities do not decrease (or increase) the reasonable assurance surrounding their existence in the foreseeable future.

INTRODUCTION

In South Africa, Small Medium and Micro Enterprises (SMMEs) were first formally introduced in 1996 through the publication of the National Small Business Act No. 102 of 1996. In this legislative document the term SMMEs were defined as separate and distinct business entities, managed and/or owned by at least one owner(s), while operating their respective business in any sector and/or subsector of the South African economy (South Africa, 1996). Over the years research justifies the significant roles which these business entities add towards the attainment of relevant socio-economic objectives – mainly related to the creation of employment opportunities and poverty mitigation (Amra, Hlatshwayo, & McMillan, 2013; Agwa-Ejon & Mbohwa, 2015). More specifically, South African SMMEs are believed to provide employment opportunities to at least 60% of the national workforce while also contributing more than 40% to the national Gross Domestic Product (Fatoki & Odeyemi, 2010; Booyens, 2011; Tshabalala & Rankhumise, 2011).

Regardless of the above, academic literature suggests that these business entities are not attaining their socio-economic objectives as expected by national government (Fatoki & Odeyemi, 2010; Bruwer & Coetzee, 2016). This sentiment is supported by previous studies where it is reported that South African SMMEs have one of the worst sustainability rates in the world – at least 75% of these business entities have the tendency to fail after being in operation for less than four years (Olawale & Garwe, 2010; SEDA, 2010; Wiese, 2014). This immense failure rate of South African SMMEs is exacerbated by numerous economic factors, as spurred on by a non-conducive economic environment[10] (Radas & Božić, 2009; Lazzeretti & Petrillo, 2006; Siwangaza, 2013; Bruwer, et al., 2013). In turn, also in a South African dispensation, economic factors and the non-conducive economic environment contain inherent risks which, if uncontrolled and unmanaged, can adversely influence the sustainability of SMMEs, and possibly also their actual existence in the foreseeable future (Herrington & Kew, 2013; Vawda, Padia, & Maroun, 2013). One manner in which relevant risks can be mitigated is through the utilisation of internal controls activities.

The term “internal control activities” alludes to those activities, as supported by policies and procedures, which are implemented by management, with the main objective to prevent and detect potential risks-events from taking place in order to provide reasonable assurance regarding the attainment of relevant business objectives in the foreseeable future (COSO, 2006; Ejoh & Ejom, 2014). Moreover, internal control activities are generally grouped into five categories, namely: 1) segregation of duties, 2) proper authorisation activities, 3) adequate document usage and design, 4) safeguarding of assets, and 5) independent checks (COSO, 2013). With the above in mind, and in a South African SMME dispensation, it is concerning to note that internal control activities are only used to a limited extent (Jackson, Holland, Albrecht, & Woolstenhulme, 2010; PWC, 2011). Moreover, a study found that these deployed internal

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[10] The economic environment of South Africa measures its overall economic “health”, as measured by core economic indicators. In recent times, South Africa’s economic environment has been described as non-conducive for small businesses to operate in; become sustainable in (Bruwer & Van Den Berg, 2017).

control activities are inadequate and/or ineffective in their approach to mitigate risks appropriately (Bruwer, 2016). Placing emphasis on the above-said, it becomes apparent that the internal control activities implemented in South African SMMEs are not adequate and/or effective in providing reasonable assurance surrounding the mitigation of risks, or with the attainment of their relevant business objectives. It is however unclear whether these internal control activities actually provide reasonable assurance that these business entities will remain in operation for the foreseeable future.

For the remainder of this paper, discussion takes place under the following headings: 1) literature review and statement of hypothesis, 2) research design, 3) results and discussion, 4) managerial implications, and 5) conclusion and suggested avenues for further research.

LITERATURE REVIEW AND STATEMENT OF HYPOTHESIS

As this study made use of linear regression analysis (see Section 4), discussion for the remainder of this section takes place under the following three sub-headings: 1) South African SMME failure and the South African economic landscape, 2) internal control activities in general and in South Africa, and 3) statement of hypothesis.

South African SMME failure and the South African economic landscape

Across the globe SMMEs are deemed to be critical in the socio-economic development of both developing countries and developed countries (Sanda, Sackey, & Fältholm, 2011). This is particularly supported by these business entities' abilities to create employment opportunities and to alleviate poverty. In a South African dispensation, SMMEs are responsible for providing employment opportunities to around 60% of the national workforce while simultaneously contributing approximately US$ 123.82 billion to the national economy (Carter & Van Auken, 2006; SEDA, 2016).

Notwithstanding the above, South African SMMEs do not have a sound sustainability track-record, as supported by Global Entrepreneurship Monitor (GEM) rankings (Herrington, Kew, & Kew, 2009). During the course of 2009, South Africa ranked 35th out of 54 participating GEM countries with a reported Total Early stage Entrepreneurial Activity (TEA) rate of 5.9%. In layperson's terms, this indicator translates to the phenomenon that only 5.9% of all South African citizens between the ages of 18 and 64 were involved in nationally based SMMEs which have been in existence for up to 42 months. Although the South African TEA rate increased to 7.0% closer to the mid-2010s, the ideal TEA rate, based on the estimated size of the population, for South Africa is believed to be in the region of 13% (Sexton, 2017). The weak South African TEA rate can most probably be explained by the extensive failure rate of South African SMMEs.

According to Radipere and Van Scheers (2005), during the mid-2000s, 40% of South African SMMEs fail in their first year of operation, 60% in their second year of operation, and 90% after their tenth year of operation. The failure rates of these business entities are often regarded as one of the worst in the world as, in more recent times, an average of 75% of South African SMMEs have been reported to fail after being in existence for only three years (Pretorius, 2009; Olawale & Smit, 2010). Over the years, an array of reasons have been provided for the latter dispensation however the most prominent reason provided is that these business entities are adversely influenced by realised risks which, in turn, stem from unmanaged economic factors and/or a non-conducive economic environment (Turton & Herrington, 2012; Masama, 2017).

According to previous studies (Remenyi & Heafield, 1996; Tchankova, 2002; Smit, 2012) South African SMMEs are exposed to strategic risks (possible events which may directly impact the attainment of a business entity's vision and mission), operational risks (possible events which may directly impact the economy, efficiency and effectiveness of a business entity's operations), reporting risks (possible events which may directly impact the financial and/or non-financial information of a business entity; used to make decisions) and compliance risks (possible events which may directly impact the overall compliance of a business entity in relation to rules, regulations, policies and procedures). Examples of these risks include a sudden changes in market shares, unproductive human resources, errors in internally generated reports, and non-corrective action taken with misconduct by human resources. These aforementioned risks stem from an unconducive economic environment and/or repercussion of unmanaged economic factors. In turn, these phenomena have an adverse influence on the overall sustainability of these business entities (Bruwer & Coetzee, 2016). One manner in which risks can be managed is through the implementation of adequate and/or effective internal control activities. Such activities should provide reasonable assurance surrounding the attainment of business objectives (and the actual existence) of a business entity, in the foreseeable future (Pressly, 2009; Siwangaza, 2013; Bruwer, 2016).

Internal control activities in general and in South Africa

Internal control activities are those activities, as established and implemented by management, as supported by formal policies and procedures, to detect and prevent potential risk-events when realising and/or from realising, with a specific end goal to attain business objectives in the foreseeable future (COSO, 2013; Gyebi & Quain, 2013). These activities are generally grouped into five categories, each of which is listed and explained upon below (Little & Best, 2003; Agbejule & Jokipii, 2009; Gramling, Hermanson, Hermanson, & Ye, 2010; Frazer, 2012):

1. Segregation of duties: It pertains to the allocation of core tasks to unique individual internal stakeholders in order to successfully complete a transactional cycle. Otherwise stated, the person responsible for authorising transactions should be different to the person responsible for executing transactions, should be different from the person recording transactions.
2. Proper authorisation activities: It refers to the basis by which management gives permission, either in person or through the delegation of authority, for relevant activities to take place within a business dispensation.
3. Adequate document usage and design: It holds relevancy to the usage of supporting documents (e.g. source documents), which are properly designed to validate the occurrence and justify the legitimacy of properly authorised transactions (and activities) which took place in the past.
4. Safeguarding of assets: It alludes to control interventions which are put in place to assist with the physical protection and/or virtual protection of tangible assets and/or intangible

assets which are owned by a business entity. Examples of such control interventions include that of access controls, the use of security guards and alarm systems.

5. Independent checks: It has to do with random checks which are performed to ensure that a business entity is operating reasonably within the boundaries of set compliance criteria (e.g. policies, procedures, regulations and legislation). Examples of such checks include that of reconciliations, surprise cash checks and periodical stock counts.

With the above in mind, when focus is placed on the internal control activities which are implemented in South African SMMEs, a recent study Bruwer (2016) found that these business entities make use of customised internal control activities which are not adequate and/or effective in their approach to mitigate risks. The findings of Bruwer (2016) is quite concerning as, a study conducted by PWC (2011) found that the internal control activities implemented by South African SMMEs have been labeled as “inappropriate” in their tasks to mitigate risks. Moreover, in two local studies (Siwangaza, 2013; Bruwer, Coetzee, & Meiring, 2017) the foregoing is supported by the finding that the internal control activities used by these business entities do not provide reasonable assurance surrounding the overall attainment of relevant business objectives in the foreseeable future.

Statement of hypothesis

Taking into account the above, internal control activities should provide reasonable assurance to management surrounding the attainment of business objectives and possibly the actual existence of the relevant business entity too. Notwithstanding the latter, academic literature suggests that implemented internal control activities in South African SMMEs do not provide reasonable assurance surrounding the attainment of relevant business objectives (see above). Since no previous studies have been conducted on whether implemented internal control activities in South African SMMEs provide reasonable assurance regarding their existence (in years), the following hypothesis was developed and tested within the ambit of this paper:

H_1: *The implemented internal control activities in South African SMMEs, as perceived by management, has a negative statistically significant influence on the reasonable assurance provided surrounding the existence of these business entities.*

RESEARCH DESIGN

For this section, relevant discussion takes place under the following two headings: 1) study and participants, and 2) model specification.

Study and participants

This study was both empirical and exploratory in nature, and also constituted quantitative research. As the study fell within the positivistic research paradigm, survey research was conducted. This particular approach was followed to collect primary quantitative data from respondents, all of whom had to adhere to the following delineation criteria:

- Each respondent had to be regarded as a member of management of their respective SMME.
- Each respondent's SMME should have been a sole trader, partnership, close corporation or a private company.
- Each respondent's SMME should have been regarded as non-franchised.
- Each respondent's SMME should have operated in the fast moving consumer goods industry.
- Each respondent's SMME should have been in existence for at least one year.
- Each respondent's SMME should have employed between one and 50 full-time employees.
- Each respondent's SMME should have operated in the Cape Metropole, South Africa.

The delineation criteria used were decided on as previous studies have made use of similar delineation criteria when conducting empirical research on South African SMMEs (Siwangaza, 2013; Bruwer & Van Den Berg, 2016; Masama, 2017).

A questionnaire was used to collect data from respondents which comprised of 34 closed-ended questions; mostly taking on the form of five-point Likert-scale questions (1 = strongly disagree, 2 = disagree, 3 = neither agree nor disagree, 4 = agree, 5 = strongly agree). For this study, data pertaining to eight of these questions were analysed in order to test the developed hypothesis.

Non-probability sampling methods were used to select a representative sample size; comprising a mixture of purposive sampling and convenience sampling. The latter sampling method was justified by the actualities that: 1) the size of the population was unknown to the authors, 2) this study had to be conducted in a limited timeframe of two months, and 3) the authors were based in the Cape Metropole (South Africa) for the duration of the study. In core, 120 respondents were targeted (face-to-face) of which only 119 were found to be valid (99.17%). All relevant responses received from respondents were captured and analysed through means of both descriptive statistics and inferential statistics using SPSS (version 24).

Model specification

In order to test the developed hypothesis in this study, two questions were used to measure the dependent variable (comprising one item) and independent variable (comprising 34 items). The number of items applicable to the independent variable was reduced[11] to four factors and three items through means of principle axis factoring[12]. A summary of the reliability tests (Cronbach Alpha) and KMO test scores are shown in Table 1. For all four valid factors, applicable average-scores were calculated for variables which were used during the linear regression analysis.

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[11] The decision to reduce the number of items applicable to the independent variable was to reduce multicollinearity.

[12] While performing principle axis factoring, a factor is only regarded as valid if its Cronbach's Alpha value and KMO test score are at least 0.600 (Field, 2009; Cohen & Sayag, 2010).

Table 1: Summary of reliability tests and KMO scores pertaining to the independent variable

Factor tested	Number of items tested	KMO score	Cronbach's Alpha
Document usage and design[#]	11	0.867	0.853
Authorisation	3	0.374	0.380
Safeguarding of assets[#]	9	0.798	0.800
Independent checks[#]	8	0.824	0.858
Segregation of duties[#]	3	0.718	0.829

[#] Valid factor as KMO scores and Cronbach Alpha values were ≥ 0.600.
Source: Researchers' own construct

The linear regression analysis performed was done in such a manner to ascertain whether internal control activities provide reasonable assurance surrounding the existence of South African SMMEs in the foreseeable future. To achieve the latter, the following regression model[13] was used:

$$EXIST = \alpha + \beta_1 DOC + \beta_2 MAN + \beta_3 EMPP + \beta_4 EMPM + \beta_5 SAF + \beta_6 IND + \beta_7 SEG + \varepsilon.$$

For clarity, each variable in the regression model above is described in Table 2.

Table 2: Description and measurement of variables in the regression model

DEPENDENT VARIABLE		
Variable	**Description**	**Measurement**
EXISIT	The probability of SMMEs remaining in existence in future (item)	It measures the likelihood, according to respondents, that SMMEs will remain in existence for the foreseeable future. It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
INDEPENDENT VARIABLES		
Variable	**Description**	**Measurement**
DOC	Document usage and design (factor)	It measures whether document usage and design in SMMEs (e.g. source documents) are used. It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
MAN	Only management may authorise transactions (item)	It measures whether only management may authorise transactions. It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
EMPP	Employees may authorise transactions based on policies/procedures (item)	It measures whether only employees may authorise transactions based on formal policies and procedures. It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
EMPM	Employees may authorise transactions	It measures whether only employees may authorise transactions based on management's approval. It

[13] The symbols "α" and "ε" represent the constant(s) and error(s) in each model.

	with management's approval (item)	assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
SAF	Safeguarding of assets (factor)	It measures the usage of proper interventions to safeguard significant current- and non-current assets in SMMEs (e.g. source documents). It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
IND	Independent checks (factor)	It measures the usage of independent checks in SMMEs (e.g. source documents). It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".
SEG	Segregation of duties (factor)	It measures the usage of segregation of duties in SMMEs (e.g. source documents). It assumes a value between 1 and 5 where 1 is synonymous with "strongly disagree" and 5 means "strongly agree".

Source: Researchers' own construct

RESULTS AND DISCUSSION

For this section, relevant discussion takes place under the following two headings: 1) brief summary of descriptive statistics, and 2) linear regression analysis.

Brief summary of descriptive statistics

Respondents were asked an array of closed-ended questions (comprising multiple choice questions) to help identify the demographical characteristics of both respondents and their respective SMMEs. A summary of the latter is shown below:

Respondents

- Position: 40.34% were owners, 32.77% were managers, 26.89% were owner-managers.

SMMEs

- Type of business: 77.30% were sole traders, 9.20% were partnerships, 10.10% were close corporations, and 3.40% were private companies.
- Status: 100% were non-franchised.
- Industry: 100% were in the fast moving consumer goods industry.
- Full-time employees: 87.40% had between one and ten full-time employees, 12.60% had between 11 and 50 employees.
- Existence: 24.37% existed for between one and four years, 75.63% existed for at least four years.
- Geographical location: 100% were based in the Cape Metropole, South Africa.

Using the above as a basis, on average, a respondent was regarded as an owner of a sole trader, non-franchised, fast moving consumer goods SMME, based in the Cape Metropole which, in turn, had between one and 10 employees while being in operation for at least four years. Furthermore respondents were asked to rate their agreement with the statement that their respective SMMEs will remain in operation in the foreseeable future – a total of 84.90% of respondents were in agreement, 13.40% of respondents were unsure, while 1.7% of respondents disagreed.

Linear regression analysis

The linear regression analysis performed was done in order to ascertain whether internal control activities deployed in South African SMMEs have a positive statistically significance on the reasonable assurance surrounding the existence of these business entities in the foreseeable future. In Table 3 a summary of the results is shown, where after it is discussed in more depth.

Table 3 *Summary of linear regression analysis performed*

		EXIST
Independent variables	R2	0.142
	F	0.439
	Sig.	0.001
DOC	Std β	-0.027
	Sig.	0.843
MAN	Std β	0.229**
	Sig.	0.026
EMPP	Std β	-0.052
	Sig.	0.570
EMPM	Std β	0.041
	Sig.	0.660
SAF	Std β	-0.451***
	Sig.	0.002
IND	Std β	0.129
	Sig.	0.295
SEG	Std β	0.357***
	Sig.	0.003
*** Significant at the 1% level ** Significant at the 5% level		

Source: Researchers' own construct

Based on the calculated R^2 (14.20%), the inference can be made that the regression analysis performed expressed a weak explanation of the variances which existed among applicable variables. In layperson's terms, although three of the seven tested relationships were found to be statistically significant, the gradients of these relationships were not solely positive or solely negative (see Std β-values in Table 3).

From the tested relationships, positive statistically significant relationships were identified between SEG and EXIST (β = 0.357) (at a 99% confidence interval), as well as MAN and EXIST (β = 0.229) (at a 95% confidence interval). There was also a negative statistically significant relationship between SAF and EXIST (β = -0.451) (at a 99% confidence interval).

Using the aforementioned as a basis, the following statistically significant predictions can be made:

- When sampled South African SMMEs make use of SEG and MAN as internal control activities, it will increase the reasonable assurance surrounding the EXIST of these business entities.
- When sampled South African SMMEs make use of SAF as internal control activity, it will decrease the reasonable assurance surrounding the EXIST of these business entities.

According to academic literature, internal control activities, in general, should provide reasonable assurance surrounding the attainment of business objectives which, in turn, should allow for a business to remain in existence. Stemming from the results in Table 3, it appears that one internal control activity significantly decreased the reasonable assurance surrounding the EXIST of sampled South African SMMEs; two internal control activities significantly increased the reasonable assurance surrounding the EXIST of South African SMMEs, and four internal control activities did not significantly influence the EXIST of South African SMMEs at all. As a result, since majority of perceived internal control activities did not have a statistically significant influence on the EXIST of sampled South African SMMEs, H_1 was rejected.

MANAGERIAL IMPLICATIONS

South African SMME management should pay close attention to their implemented internal control activities, particularly those related to SAF. From the results, it appears that internal control activities applicable to SAF decrease the reasonable assurance provided that these business entities will remain in existence in the foreseeable future. Probable reasons for the latter may include that implemented internal control activities pertaining to SAF are static, not periodically monitored, ineffective and/or inadequate. In quintessence, implemented internal control activities should add value to the overall sustainability of a business entity – providing reasonable assurance surrounding the attainment of relevant business objectives to, in turn, help these business entities to remain in existence for the foreseeable future. All in all, the onus rests on South African SMME management to make use of internal control activities which are adequate (enough) and/or effective (working as intended) as there exists no such thing as “one-size-fits-all” internal control activities.

CONCLUSION AND SUGGESTED AVENUES FOR FURTHER RESEARCH

Regardless of the socio-economic value which South African SMMEs add to the national economy, it is disconcerting to note that these business entities have one of the worst failure rates in the world. Over the years an array of possible reasons for the latter dispensation has been highlighted; most of which are strongly related to the realisation of risks which stem from unmanaged economic factors and/or a non-conducive economic environment. Unfortunately, even with this knowledge available the overall sustainability of South African SMMEs has not improved to a great extent. One manner in which risks can be mitigated is through the implementation of internal control activities however, academic literature suggests that such initiatives, in these business entities, are inadequate and/or ineffective in their approach to provide reasonable assurance surrounding the attainment of relevant business objectives.

Stemming from the results of this study, clear tangent planes emerge that internal control activities may possibly play a role in providing reasonable assurance surrounding the actual existence of South African SMMEs however it was not the case in the selected sample. It was found that since two (28.57%) of the tested internal control activities had a positive statistically significant influence on EXIST, one (14.28%) of the tested internal control activities had a negative statistically significant influence on EXIST, while the remaining four (57.14%) tested internal control activities did not have any statistically significant influence on EXIST. Hence, H_1 was rejected since the majority of internal control activities implemented in South African SMMEs did not have any statistically significant influence on their EXIST in the foreseeable future.

Although not justified by the results, it may be possible that the internal control activities which were implemented in sampled South African SMMEs may have been inadequate and/or ineffective in their mitigation of risks, especially since four internal control activities had no statistically significant influence over the EXIST of South African SMMEs.

Suggested avenues for further research include, but are not limited to: 1) identifying the characteristics of implemented internal control activities in South African SMMEs, and 2) evaluating the importance of implemented internal control activities in South African SMMEs to mitigate risks.

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