

When Internal Control is Effective for the Firms, is it Effective for Small and Medium Enterprise?

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The existence of Small and Medium Enterprise (SME) is one of the important factors supporting the country's economy, because it helps to alleviate poverty, whilst acting as a source of foreign exchange for the country. However, in the last three years, the number of SMEs in Indonesia, and especially in the Magelang Regency, has decreased quite dramatically. Hence, this study was conducted to analyse the effectiveness of internal controls carried out by Small and Medium Industries (SMIs), which have functioned as one of the supporting systems for business operational sustainability and effectiveness in large companies. This study uses a mixed method to answer the research objectives. This study, conducted on 100 SMEs, resulted in the finding that only two COSO indicators had a statistically significant effect on internal control; namely, communication and information. Whereas, control environment, risk assessment, and control activities had no significant effect. This finding is reinforced by the results of the group discussion forum, in which SME was only able to do these two things, be it simply and without standardised control. Thus, COSO's internal control has not been effectively applied to SME. Meaning, it has the potential to suffer from bankruptcy when it is unable to anticipate problems, especially those originating from external fluctuations.

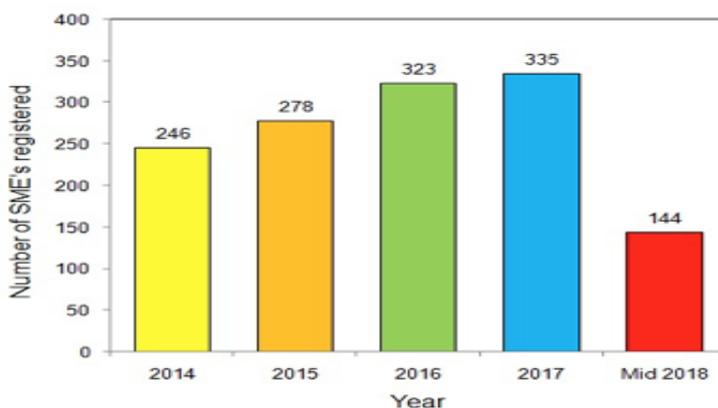
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Preface

One of the bases for the preparation of Small and Medium Enterprise (SME) is the Law of the Republic of Indonesia Number 25 of 2000, concerning the National Development Program (PROPENAS), which is followed by Law Number 3 of 2014, concerning industry to provide a strong foundation for the implementation of national industrial development, specifically the empowerment of SME. The Development of SME is one of the strategic steps to reduce poverty and community dependence on the economic sector. SME has an important role in the Indonesian economy, which includes being a major player in economic activity in various sectors; being the largest employer; being an important player in the development of regional economic activities and community empowerment; being a new market creator and innovator; and contributing to maintaining the balance of payments through its contribution in producing exports, especially for Small and Medium Industries (SMI) that have penetrated the international market (Wati, 2011).

In Magelang, based on data from the Department of Industry and Trade of Magelang Regency in 2017, the prevalence of SME was around 360. This large number indicates a fairly high micro economic growth. On the other hand, the potential or target market for SME is wide open and has very good prospects. An interesting phenomenon in the Magelang Regency is that in mid-2018, based on field conditions, the prevalence of surviving SMEs had changed drastically with only 144 remaining. This condition is due to the free trade competition and crisis, meaning that SMEs had failed and gone bankrupt and were not developing. (illustrated in Figure 1). This is something that until today, remains a problem in the Regency Government relating to the development of SMI (Disperindakop, 2018).

Figure 1. Data on the development of SMI



The existence of SME is one of the efforts that has a big impact in supporting the community economy. Even when a crisis hits Indonesia, many small industries are able to survive. However, with the co-existence of the free trade competition and crisis, there are also SMEs

that become bankrupt. Therefore, small industries should take into account any factors that lead to bankruptcy. Based on the work of Soinen, Puumalainen, Sjögrén, and Syrjä (2012), the factors leading to the bankruptcy of SMI includes the lack of an effective internal control system.

Several studies were conducted regarding this topic, namely Osefuah (2015). The study examined internal control systems in small and medium medical practices in the municipality of Thulamela, South Africa, where all owners and/or managers strongly agreed that effective internal control is required for business success. Internal control is very important in managing small business resources (Sankoloba & Swami, 2014), so owners and employees must be capable of independently gaining knowledge regarding internal control. In addition, the owners realise that internal control must exist in their businesses, but cannot maximise the effectiveness of internal control for profit. Improving internal control can help SME managers to minimise the loss of company assets and increase profitability, which in turn can increase corporate social responsibility to the Aladejebi community (2017). The internal control system and improved performance were apparently inseparable from the business strategy (Hadi, 2008).

Business strategy provides many influences in the internal control system. According to Luyolo et al (2014), most SMI managers do not want to build an internal control system because of the limited human and financial resources for its operation. During this time, the internal control system SMEs used, refers to internal controls designed for large companies, even though the internal control criteria of large companies is different. If it is applied to a small company, it is almost certain that the small industry will have a weak control. Therefore, it will have difficulties that could lead to various possibilities, such as the refusal to audit the small company, unreasonable reactions that lack conditions, and incurring very large inspection fees (Ihsan and Sulastri, 2005). Zong Xiusong (2006) argues that there are many internal control problems in the SME. Namely, a lack of understanding of internal control, a lack of constraints in management mode, and a lack of effectiveness of internal control objectives. Hence, companies need to strengthen moral education and education of internal control systems for all staff, establish effective internal control systems and strengthen supervision. Zheng (2011) suggested that the problem of internal control for SMEs is the weakness of the internal audit function. Therefore, companies need to strengthen internal control audits. Only thirty-eight per cent of small businesses can run in under five years, according to Sankoloba and Swami (2014). The poor condition of small businesses is due to the lack of a proper internal control, in which small businesses experience fraud and misuse of their assets (Bishop, 2004). As a result, they cannot survive and hence, fail to run their business in less than five years. This illustrates that internal control has a role in managing business resources. Material weaknesses are more likely to occur in smaller, weaker, and inexperienced companies (Doyle et al., 2005). This study aims to find out how

effective and how important internal control is for SME, especially in the district of Magelang. Theoretically, the internal control system is very important and should be applied by SMEs so that SME can develop and compete in the current environment.

Research methods

Quantitative and qualitative methods are used in this study with the aim of obtaining complete and accurate data and information. Firstly, data was obtained by surveying questionnaires distributed to 100 respondents of SMEs in the Magelang Regency. This data was then processed and tested to ensure its reliability, then the model tests were performed using a path analysis. Secondly, in-depth interviews were conducted through focus group discussions with 35 SME owners, who have been running for at least one year and were used as respondents to extract deeper information related to internal controls conducted at SMEs. The final step combines the results of the path analysis test with the results of the interview, so that the respondents' answers are accurate and in-depth. One of the questions that this research wants to answer, is whether or not internal control is implemented at SMEs. This question is analysed using the path analysis test to assess whether the internal control element is implemented in SME.

Research Results and Discussion

Based on the results of the questionnaires distributed to SME participants in the Magelang District, several elements of internal control appear to have significant positive and negative effects. The elements that have a significant positive effect are information communication and monitoring. Whereas, control environment, risk assessment and activity control, have a negative effect. This can be seen in the Path Analysis Test Table as follows:

Table 2: Test Path Analysis

	Estimate	S.E	CR	P. Label
Ce □ Control	-.267	.120	2.153	***
Ra □ Control	-.300	.078	3.846	***
Ic □ Control	.267	.056	4.767	***
Con □ Control	-.231	.033	7.000	***
Mon □ Control	.254	.042	5.126	***

Source: Primary data processed, 2018

It can be observed from the Standard Error and P Label values in Table 2, that the values for control environment and risk assessment, as well as control activities, are negative. Namely -0,231; -0.300 as well as -0.267. While, for information communication and monitoring there is a positive value of 0.267 and 0.254. From the results of the tests conducted, it can be

illustrated that not all internal control factors based on COSO (2013) can be implemented in SMEs.

Based on the observations and interviews with participants, overall, participants understand internal control well. In fact, participants understood that their activities would greatly affect their businesses and make the community's trust stronger when internal control is applied. In addition, the participants also understood that their roles as both managers and employees were part of the business. In general, the public understands that business is an activity for profit, so business requires good internal control. According to the informant, it turns out that not all elements of internal control as according to COSO (2013) — where internal control consists of the five elements of control environment, risk assessment, control activities, information and communication, and monitoring — can be carried out at SMEs. This result is consistent with quantitative data; namely, only two elements of internal control in the form of information communication and monitoring can be implemented at SMEs.

Discussion

Based on Table 2, the test path analysis shows control environment, risk assessment, and control activities are negative, while information communication and monitoring elements are positive. This illustrates that only information communication and monitoring elements are currently being implemented, whilst control environment and risk assessment elements, as well as control activities, are not being carried out properly. The SME participants regard smooth communication, information delivery and monitoring from the owners as sufficient. In addition, if active control and risk control are to be carried out, they should be carried out by external parties because SME participants are constrained by costs. This is what makes many high schools in the Magelang Regency bankrupt and hinders healthy development, because monitoring is done simply by the owner. Even though participants of SMEs are aware and understand the importance of internal control that includes the five factors (COSO, 2013), they continue to say that simple routine monitoring, smooth communication and information, both internally and externally by the SMEs through the forum, are enough to ensure the sustainability of the SMEs in the Magelang Regency. As many as 80 per cent of the SMEs in the Magelang Regency are not guided by an internal control system that refers to the five elements of control environment, risk assessment, activity control, information communication and monitoring. This is supported by the results of Jia's research (2016) in China, that there is a problem. Namely, the lack of internal control standards for SMEs in real terms. In contrast to Oseifuah's research (2015), that all owners and/or managers of small and medium medical practices strongly agree that effective internal control is needed for business success.

In practice, there are higher cost constraints in implementing internal control. Most of the available resources for managing records are implemented individually or not at all. In addition, the owners feel that they are not interested in bookkeeping management activities because they are too busy and lack internal control at the SME, thus resulting in the misuse of business resources.

Control environment

The control environment is an element with a negative value and hence, is not carried out in SMEs. It can be observed that SMEs have a different environment than large companies. Large companies have top management ranks known as Directors and structured arrangements with existing Units and/or Departments. Large companies have a Board of Commissioners to help run the business well and can determine internal audits to oversee the existing internal control. Meanwhile, SMEs have a very simple organisational structure with managers and subordinates, and even the managers act as subordinates. The informant explained that the organisational structure and governance were not owned, hence the flow of authority and responsibility could not run ideally. Based on the experiences of several SME regarding past business failures, awareness is needed regarding the control of internal activities in SME businesses. However, until now, this awareness is not present in SMI participants. Hence, internal controls should be designed to provide guarantees in achieving objectives regarding the effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.

Currently, SME managers do not pay enough attention to internal matters, such as the need for a code of ethics, respect for employees, auditing, and carelessness in regulating business. The current SME managers only pay attention to the benefits and sustainability of the business today, as stated by COSO (2013) regarding the suggestion that internal control should be carried out independently and outside the owner. This COSO statement (2013) is in-line with the opinion of Grollman and Colby (1978), stating that the control of owners and managers is crucial because it is part of internal control over the performance of SMEs. Since small entrepreneurs do not have records and bookkeeping for the continuity of their business, small entrepreneurs think that it is relatively unimportant to apply the accounting process. In addition, employers do not yet have or understand the importance of internal control. In fact, many of them still think as traders, not as managers, who must control employees for business continuity. According to Mulyadi (2010), the internal control system includes an organisational structure, methods and measures that are coordinated to maintain organisational wealth, check the accuracy and reliability of accounting data, encourage efficiency and encourage compliance with management policies.

There are several SMEs that already have very advanced businesses, so they have several employees and an almost complete organisational structure, like large companies. However, there are still many shortcomings in existing internal control. One of them, is the absence of a clear separation between the warehouse and the recording section, so data mismatches often occur within SME. For example, when a customer returns an item that is not in accordance with the order, the original memo is not taken back, but a new memo is made. Therefore, a double recording can occur. In addition, because there is no stock of goods available in the warehouse, SMEs often disappoint customers as the goods ordered are often not as expected or don't even exist due to limited supplies. Within SME there is also no Standard Operating Procedure (SOP) for each type of resource management activity (SOP is a tool used by internal auditors as a measure of performance or determining criteria for each audit conducted). As seen above, the control environment at each of the high schools is not complete, so the implementation is very far from commitment and consequence. The results of this research are different from those of Oseifuah (2015). The majority of businesses exhibit a strong control environment because 80 per cent of respondents indicated they have set acceptable business policies and practices. Likewise, 80 per cent of businesses show that their employees are informed about these policies.

Risk assessment

In SME, most of the operational funds come from their own capital. Informant A states that the highest risk associated with expenditure is from the sale of goods and services because it is related to the method of shopping. Which, is sometimes without a valid black and white agreement and is based on trust, so that it is vulnerable to failure in transactions. Errors in the selection of procurement methods can be suspected as a lack of understanding or compulsion because of the need to sell immediately. Another crucial point is that the managed funds are combined with private funds, leading to funding difficulties in the next production process. Moreover, SMEs find it difficult to manage existing finances due to a lack of human resources.

Control activities

The resulting control activity element is a negative value. So far, SMEs have not conducted audits by internal parties or external parties. As the first pillar of the control function, internal auditing should be the first thing assessed by an external examiner. Henceforth, internal control should be able to reduce all forms of irregularities that may occur, including fraud. This is illustrated by the following SMI owner's response:

"Finance is always taken note of, but there are no audits from other people, they're all self-managed. In fact, I didn't separate business transactions from personal finance. Yes, just keep it in mind "

—Wahyudi, 45 years old, owner of a bamboo crafts business

"It's really complicated if we have to have an internal or external audit, so it's essentially useless. As owners, we ourselves can take care of it if we only manage finances "

—Prayitno, 50 years old, a plastic crafts business owner

Information communication

Considering the information and communication path analysis yielded positive values, we can deduce that SME controls this element. One important element of internal control carried out by SMI in the Magelang Regency, is the openness of information and communication delivery between SME owners and their employees. The manager, as well as the owner of SMIs, routinely have good formal communication through both scheduled and unplanned meetings with their employees. This is done in order to create closeness and openness. Management always communicates with employees when there is a change in the business strategy or in the form of products that suit the market. In addition, the management of SMIs also continue to actively communicate with outsiders in order to market and meet market demand. Some of the SME managers said that communication with outsiders through the network is very important for the success of SMI in the future. This communication, in addition to market potential, is also helping cooperation to increase employee expertise in supporting product innovation that follows market demand. However, training provided from outside parties — especially the Government — sometimes doesn't meet the expectations of SMEs. The results of this study are consistent with the research of Oseifuah (2015), that 80 per cent of respondents communicate new product information to nursing staff. Likewise, 93.3 per cent agreed that it was important to communicate with staff to ensure awareness of their responsibilities. This form of communication and information can be strengthened through the following testimonials given by one of the SMI managers:

"The training provided by outside parties usually does not fit into the initial schedule in a timely manner. Even with this training, sometimes we meet consumers so that there can be direct cooperation, but yes the collaboration is based on trust. Goods are sent first, without any prior payment terms or black and white cooperation "

—Ayu, 47, owner of a zinc and aluminium crafts business

The same point made about the training, was also conveyed by Mr. Wahyudi, owner of a bamboo handicrafts business. Though, his views varied regarding the cooperative relationship with the external party:

"Training is only an annual agenda, sometimes less effective too, though it does provide an opportunity for employees to improve their expertise. Since in my high school, every employee can do different jobs, there are no specifications. Regarding cooperation, I have a different stance to Mr. Bayu, for me, cooperation with outsiders is definitely made with a clear agreement. "

Some SME owners have the same rules as Mr. Wahyudi, and they even blame Mr. Bayu regarding cooperation and business relations with external parties. Without a clear agreement, and only one made through oral communication, there will be a significant potential risk that affects the activities and performance of SMEs. Hence, all forms of cooperation must be clearly communicated through agreements. This is confirmed by the following statements:

"Even with online marketing, large transactions must still be an agreement, including exports for which there is cooperation. Usually there are other distributors who take the goods themselves. To improve the ability of employees, the concept of empowerment should be applied so employees can continue to develop and gain knowledge according to their wishes.

—Bejo, 55, owner of a wig and mask crafts business

"Cooperation with a clear agreement is always done for all large stores such as Mirota Cirebon, Mirota Surabaya, and Mirota Yogyakarta. For all policies that the owner arranges, individual employees carry out their duties. "

—Anhari, 53 years old, owner of a silver craft business

Monitoring

As identified, the monitoring element path analysis yielded positive results. The results obtained from the two methods consisted of not all factors pertaining to the internal control (COSO, 2013) of the SMEs. Of the five factors that influence the company's internal control, the one which corresponds and is carried out by SMEs is the monitoring element. Monitoring of every activity is carried out by SMEs, even though most of it is done by the manager and owner of the SME itself. The owner intensively monitors SME operational activities for employees (internal) and shares them with fellow SMEs (external) as routinely scheduled. In monitoring the daily activities of the SME, SME owners exercise control individually without the assistance of internal or external auditors. Monitoring is done by the owner himself. The

reason is for cost and time efficiency. SMEs have a very small scope of business, so it will be less effective or efficient if there is a special section tasked with conducting controls and audits. The application of internal and external controls requires additional costs and human resources. This answer was obtained from an SME owner and strengthened by several other SME owners. The majority want to simplify and streamline the process. They want something that is fast, easy, and doesn't cost more. This is illustrated by the following comments of SME owners:

"Finance is always take note of, but there are no audits from other people, everything is controlled by ourselves. In fact, I don't separate business transactions from personal finance. Yes, just keep this in mind "

—Wahyudi, 45, bamboo crafts business

"It's really complicated if we have to have an internal or external audit, so its essentially useless. As owners we ourselves can be independent if we just manage finances"

—Prayitno, 50, plastic crafts business owner

Based on these testimonials, we can also conclude that in SMEs in Magelang, there is a potential conflict of interest between owners and employees, as the control and financial activities are carried out by the owner, causing a financial merger between personal money and that which is yielded from business transactions. This is responsible for the chaotic financial records in SMEs, which may lead to bankruptcy. In spite of this, the owners did not realise, even though they said it has collapsed due to lack of financial control, but this is not a cause for concern.

"The financial control at the SMI was carried out by my wife. There is clear and orderly bookkeeping, even though the SMI's financial status is mixed with that of the kitchen "

—Bejo, 55 years old, wig and mask crafts business owner

Regardless, the SME owners realise the importance of procedural control carried out by both internal and external parties, because the aim is to protect assets and reduce the risk of fraud. The results of this study are not consistent with Jiang's (2010) research, stating that internal control in small companies is easier than larger companies. However, this study is consistent with Oseifuah and Gyekye (2013), the practice of internal control among small business sector companies in the Vhembe District is low, with only 45 per cent of the companies surveyed having adequate internal control systems.



Conclusion

The participants of SME have an awareness of the importance of internal control in the development of SMEs in the future. This is because internal control is very important and necessary for the continuity and sustainability of SME businesses. However, the owners only run SME businesses moderately, as there is a lack of motivation from the owners and employees to develop their SME. The participants of SME in the Magelang Regency have carried out internal controls, but these are still limited to communication and information, as well as monitoring elements. Other elements such as control environment, risk assessment and control activities, have not yet been implemented.

As for its operations, to reduce the risk of bankruptcy, SMEs in the Magelang Regency use a joint responsibility system as an alternative solution so that all parties within SME are responsible and committed to developing the SME. The joint responsibility system is also one of the characteristics of the local culture, especially in Java, Indonesia. This new finding demonstrates that the elements of internal control between large companies and SME may be different. This body of research could be further developed by looking at different locations related to SME internal control.

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