

**THE IMPACT OF INTERNAL CONTROL SYSTEMS ON THE FINANCIAL  
PERFORMANCE OF MEDIUM ENTERPRISES**

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**UGANDA CHRISTIAN  
UNIVERSITY**

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# STUDENT'S DECLARATION

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I NGABIRANO RODNEY, declare that this research report is of my own investigation and has never been carried out or submitted by anyone else.

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S21B33/094

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Date: 4<sup>th</sup> September, 2024

## SUPERVISOR'S APPROVAL.

### SUPERVISOR'S APPROVAL.

This research report has been prepared under my guidance and is hereby submitted examination with approval.

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University Supervisor.

Signature: .....*Maureen*.....

Date: .....*10th Sept 2024*.....



## DEDICATION

I dedicate this report to my parents. My father, Ngabirano Silas, and my mother, Patricia Kwarakunde, for the support during my academic struggles, and my supervisor, Ms. Natuwhera Maureen, for guiding me during this research journey

## ACKNOWLEDGEMENTS

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## LIST OF ABBREVIATIONS

<b>ABBREVIATION</b>	<b>MEANING IN FULL</b>
ICS	Internal Control System
ROA	Return of Assets
ROE	Return of Equity
ROS	Return of Sales
RQ	Research Question

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## ABSTRACT

This study examines the impact of internal control systems on the financial performance of medium enterprises. Internal control systems are critical for ensuring the accuracy and reliability of financial reporting, safeguarding assets, and enhancing operational efficiency. The research explores how effective internal controls contribute to improved financial outcomes by reducing errors and fraud, increasing operational efficiency, and supporting regulatory compliance. By analysing data from medium-sized enterprises across various industries, the study assesses the relationship between the robustness of internal control systems and key financial performance indicators such as profitability, liquidity, and financial stability. Findings suggest that well-implemented internal control systems significantly enhance financial performance by mitigating risks and optimizing resource use. The study highlights best practices for developing and maintaining effective internal controls and offers recommendations for medium enterprises seeking to leverage these systems for better financial outcomes

# **CHAPTER ONE**

## **1.0 INTRODUCTION**

This chapter presents the background to the study, the problem statement, research objectives research questions, scope of study, significance of the study and the conceptual framework.

### **1.1 Background of the Study**

Internal control Systems are techniques used by an entity, board of directors, management and other personnel so as to provide reasonable assurance regarding effectiveness and efficiency of operations and reliability of financial reporting and complete laws and regulations, emphasis should be made to achieve organisation's objectives.

Internal controls are procedures created by personnel in charge of management, governance, and other areas to offer a reasonable level of assurance regarding the accomplishment of an organization's goals concerning the accuracy and efficiency of its financial reporting, the efficacy and efficiency of its operations, and its compliance with relevant laws and regulations. It is also important to remember that internal controls give management and the board of directors of an organization just a reasonable, not a guarantee, that the organization's goals will be met. "The likelihood of achievement is affected by limitations inherent in all systems of internal control" (Hayes et al., 2005). There is a widespread belief that establishing and upholding sound internal control mechanisms would inevitably result in enhanced financial outcomes. Additionally, there is a widespread perception that effectively implemented internal control systems strengthen the accountability function of an entity's management by streamlining the reporting process and producing credible reports. However, the literature that

is now available continues to imply that financial performance has been a barrier in the majority of these businesses despite their complex systems of controls.

The study was guided by “The Agency Theory,” as initially developed by Jensen and Meckling (1976) and later expounded on by Sarens and AbdolMohammadi (2010).

The firm is seen by agency theory as a hub of agreements between the managers, who are the agents in charge of using and controlling the resources, and the principals, who are the owners of the economic resources. One of the fundamental tenets of agency theory, as proposed by Jensen and Meckling in 1976, is that agents possess a greater amount of information than principals, and that this information negatively impacts the principle's capacity to oversee whether the agents are fulfilling their obligations. The rationality of principals and agents and their pursuit of wealth maximization are further presumptions of agency theory.

Because "internal control is one of many mechanisms used in business to address the agency problem," this theory was chosen for this study (Jensen & Payne, 2003). The procedure used by the organization's leadership to guarantee the accomplishment of business goals, the accuracy and efficiency of financial reporting, the efficacy and efficiency of operations, and regulatory compliance is interpreted as internal control systems in this study (COSO, 2013). Financial performance is considered in terms of measures like profitability (using absolute and relative measures), liquidity (using liquidity ratios like current ratio, acid test ratios, and the ease with which the entity settles its financial obligations), and Accountability (in terms of financial accountability). On the other hand, Stoner

(2003) refers to performance as the ability to operate efficiently, profitably, survive, grow, and react to environmental opportunities and threats.

For the sake of this investigation, the researcher will use Ray and Kurt's definition of internal controls systems. For the purposes of this study, internal control systems were restricted to the Control Environment, Internal Audit, and Control Activities, despite the fact that internal control systems are vast and varied. Financial performance was primarily evaluated from the three perspectives of reporting, accountability, and liquidity.

#### 1.1.1 Financial Performance

Performance, in the words of Stoner (2003), is the ability to operate financially, efficiently, survive, expand, and respond to opportunities and dangers in the environment. In keeping with the foregoing, Sollenberg and Anderson, 1995 state that performance is the efficiency with which an enterprise employs its resources to achieve its goals. One way to define financial performance is the degree to which financial goals have been attained. It is a monetary representation of the outcome of a company's activities and policies. Financial statements, which are intended to give a knowledge of certain financial components of a corporate organization, can serve as a reflection of the success of an organization.

Hitt et al. (1996) mention accounting-based performance using three indicators: Return on Assets (ROA), Return on Equity (ROE), and Return on Sales (ROS). Each measure was calculated by dividing net income by total assets, total common equity, and total net sales. Positive financial performance in a credit organization can be achieved by eradicating waste in benefits services processes

and systems. The critical success factor for a credit organization is the degree to which it fulfils its set objectives and mission in terms of being efficient, effective and economical. The information obtained from a sound internal control system as reflected from financial statements will provide a report on a firm's financial performance and position that is useful to a wide range of users for assessing the stewardship and according to Stoner (2003) making economic decisions.

## **1.2 Statement of the Problem**

Despite the acknowledged importance of Internal Control Systems (ICS), there remains a gap in understanding their specific impact on the performance of medium enterprises. This study seeks to explore how effectively implemented ICS influence operational efficiency, financial integrity, risk management, and overall organizational performance within medium-sized enterprises, with a focus on identifying key factors that contribute to or hinder their effectiveness.

## **1.3 Objectives of the Study**

The study's purpose was to establish the impact of internal control systems on the performance of medium enterprises.

## **1.4 Specific Objectives**

The specific objectives of this study are the following:-

- i. To examine the impact of internal control systems on the financial performance of medium enterprises.
- ii. To examine the relationship between the internal control systems and the financial performance of medium enterprises.

- iii. To examine the key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems.

## **1.5 Research Questions**

This study shall answer the following questions:-

- i. What is the impact of internal control systems on the financial performance of medium enterprises?
- ii. What is the relationship between internal control systems and operational efficiency in medium enterprises?
- iii. What are the key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems?
- iv. What are the solutions to the challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems?

## **1.6 Scope of Study**

The scope of this study is represented in three aspects, namely;

- i) Geographical,
- ii) Time
- iii) Content dimensions

### **1.6.1 Geographical Scope**

The study is carried out in Mukono district on Bugujju road. The justification for restricting the study to Bugujju Road is due to financial constraints and lack of other resources to extend beyond this area.

### **1.6.2 Time Scope**

The study will cover two months, June and July since the researcher was able to access the data.

### **1.6.3 Content Scope**

The study is limited to the impact of the internal control systems in the financial performance of medium enterprises in Uganda especially in Mukono district. The study shall be used to suggest strategies to improve internal controls in medium enterprises. In this study, Internal Control Systems is the independent variable. The dependent variables are i) Financial Performance (derived from Research Question (RQ 1) , ii) Operational Efficiency (derived from RQ 2, iii) Risks (derived from RQ 3), and iv) Strategic Decision (derived from RQ 4).

## **1.7 Significance of the Study**

The researcher has noticed that medium enterprises often overlook the importance and impact of internal control systems on their performance.

By empirically investigating the relationship between internal controls and various performance metrics such as financial stability, operational efficiency, and overall organizational effectiveness, this research aims to offer practical guidance to medium enterprises seeking to optimize their internal processes.

Understanding these dynamics can empower medium enterprises to implement tailored internal control mechanisms that not only mitigate risks but also enhance decision-making capabilities and strategic planning.

The findings of this study shall inform policymakers and business advisors on the importance of promoting effective internal control practices among medium enterprises, thereby fostering a more resilient and competitive business sector within the economy.

According to the researcher, medium enterprises have failed to achieve their full potential as a result of poor execution of internal control systems while others are unaware of them at all making it difficult to achieve their desired goals and objectives.

# **CHAPTER TWO**

## **LITERATURE REVIEW**

### **2.0 Introduction**

This chapter covers the views, opinions and ideas of different researchers and writers about the impact of internal control systems on the performance of medium enterprises. The literature in this chapter was reviewed basing on the study of the objectives, research questions through the following ways:

### **2.1 Key concepts**

#### **2.1.1 Internal Control Systems**

Internal Control Systems are processes put in place by enterprises to help ensure the accuracy of financial reporting, compliance with laws and regulations and the effectiveness and efficiency of operations. The systems include policies, procedures and mechanisms designed to safeguard assets, prevent fraud and promote operational effectiveness within the organisation.

#### **2.1.2 Financial Performance**

It refers to an assessment of the organization's overall performance with regard to things like profitability, revenue, liabilities, expenses, and assets. Therefore, higher revenue, higher profitability, and lower levels of liabilities will be utilized to evaluate the financial performance.

### **2.1.3 Medium Enterprises**

Medium enterprises are companies that fall between small and large businesses in terms of size, revenue and number of employees. These enterprises typically have more resources and employees than small businesses but are not as large or established as big corporation the specific criteria for categorizing a business as a medium enterprise can vary by country and industry. Study will focus on supermarket, pharmacies, and fuel stations as medium enterprises.

## **2.2 The impact of internal control systems on the financial performance of medium enterprises**

Effective internal control in SMEs is linked to corporate achievement and is a crucial first step in lowering employee theft, according to Hayes (1995). 1989 saw Snyder et al. Internal controls are implemented on an ongoing basis and are designed to track and oversee employee functions through distribution of responsibilities. According to Snyder et al. (1989), the majority of SMEs failed because controls were not put in place for cash, payroll, investments, inventory, general business, accounts and notes receivable, accounts payable, sales, and property, plant, and equipment.

According to a study conducted in 2006 by Bronson et al., internal control is a useful method for assessing the performance of small and medium-sized enterprises (SMEs). Additionally, their research showed that internal control and small business success had a strong favorable association. Improved internal controls enable a company to make better decisions internally and, as a result, run a more successful organization with fewer employee fraud incidents. These data items include inventory, payables, and performance metrics. However, Peterson and Zikmund (2004) found that an effective internal control system improves

company governance by increasing employee perception of detection, which deters fraud and allows management objectives to be accomplished.

However, as Grollman and Colby (1978) reveal, executive or owner/manager control is a crucial component of internal control in the functioning of SMEs. For example, an executive in a small business is typically better positioned to exert control over the company's operations than an executive in a larger corporation. The actions of the staff, incoming orders, production and shipment schedules, products receipts, cash receipts and disbursements, and customer complaints can all be reported to him. Transaction approval is a crucial component of the executive controls. The executive should make an effort to study and normally authorize all transactions and the supporting paperwork, even though this is not practical. Thus, a search to determine the kinds of transactions, volume of transactions, practices and inventories policies is crucial.

A company, regardless of size, requires effective internal controls for a variety of good reasons. Good internal control procedures should be followed for a number of reasons, including preventing fraud, identifying embezzlement, and maintaining correct financial records. It takes some human power in addition to the controls found in the financial accounting software itself to determine whether this area is compliant. Since the majority of small business owners have very little experience with accounting, accountants are needed to serve the advisory function and help a business create and execute adequate internal controls. The application of internal control measures pertaining to accountability, independent audits, internal controls, and document retention is advantageous to numerous private enterprises.

The effect of internal control on performance has also been the subject of numerous research projects. For instance, Oseifuah and Gyekye (2013) studied the efficacy of internal controls in South African SMEs and discovered that the country's SMEs' internal control practices remained extremely low, with very few having adequate internal control systems in place. The impact of internal control systems on a firm's performance was also investigated by Dineshkumar and Kogulacumar (2013), who found a significant correlation between Sri Lanka Telecom Limited's internal control systems and firm performance. However, the study did not specifically address the impact of internal control practices on the performance of SMEs.

Kamau (2014) conducted research in Kenya on how internal control systems affect manufacturing enterprises' financial performance and found a favourable correlation between internal control and financial performance. But since the study's focus was on big manufacturing companies, it's possible that its conclusions cannot be applied to SME environments. The majority of the empirical research that have been analysed suggest that internal controls are essential to any commercial organization. Though internal control is a major factor that affects any firm's size, there isn't much data on how internal control practices affect SMEs' performance because most studies on the topic, both internationally and in Kenya, concentrate more on large companies than SMEs. This indicates, therefore, a literature gap that this study intends to determine by examining what the effects of internal control practices on performance in the financial perspective of SMEs in Nairobi County are.

### **2.3 The relationship between internal control system and financial performance of medium enterprises**

The theoretical underpinnings for establishing a connection between internal control systems and financial performance have been explored in literature. The financial performance of business organizations has been found to be correlated with certain internal control systems, such as budgeting, organization, physical authorization and approval, segregation of duties, accounting and mathematics, personnel, supervision, management, and acknowledgement of performance. [Weber, 1998}.

The 2013 COSO framework The internal control systems and operational performance of SMEs in Ondo State were assessed in the paper by Adegboyegun et al. (2020). According to their findings, internal control systems, the control environment, and control activities in SMEs all had a significant positive association. Since SMEs have limited resources at their disposal, efforts must be made to set up control mechanisms that will guarantee the best possible use of those few resources for the SMEs' maximum productivity in accordance with the Resources-based Theory. According to Barney's (1991) resource-based theory, there aren't enough resources available for commercial organizations to operate at their best. As a result, the long-term viability of commercial firms depends on ongoing access to these scarce resources. Internal control systems are meant to guarantee that organizational resources are appropriately allocated in order to accomplish organizational objectives. Internal control systems guard against waste and guard organizational assets from being mishandled or taken advantage of. Resource-based theory thus has relevance to our research since SMEs seeking a competitive edge would establish internal control procedures that facilitate the effective and efficient use of the limited resources.

Effective internal controls assist in the identification, assessment, and mitigation of risks that may have an influence on financial performance. This covers the risks of fraud, financial reporting inaccuracies, operational inefficiencies, and compliance breaches. Internal control systems help to stabilise and improve financial results by proactively addressing these risks.

Well-designed internal controls simplify operations by clearly identifying processes, roles, and responsibilities. This clarity saves duplication of effort, ensures activities are performed on schedule and precisely, and minimises resource wastage. Improved operational efficiency leads to greater financial performance via cost savings and increased productivity.

Internal controls assure the quality and dependability of financial data. This is crucial for making sound company decisions, recruiting investors, and meeting regulatory obligations. Reliable financial reporting increases credibility and transparency, which can improve the company's reputation and access to financing.

Strong internal controls include segregation of roles, regular audits, and monitoring tools. These serve to prevent fraud and errors in financial transactions and reporting. Internal controls protect the enterprise's assets and financial integrity by lowering the frequency of such accidents, consequently promoting long-term financial performance.

Regulations frequently have an impact on the operations and financial health of medium-sized businesses. Internal controls ensure that these laws and regulations

are followed, reducing penalties and legal risks. Compliance also improves the company's reputation and credibility, which can lead to a competitive advantage and better financial performance.

## **2.4 key challenges and barriers faced by medium enterprises in implementing and maintaining effective internal control systems**

SMEs are also highly significant to any country's economy, but they are particularly significant for developing and economically developing nations (Chakraborty, 2015). The majority of SMEs are truly having difficulty surviving. Even with their essential contributions to the overall economy, those that manage to survive are nonetheless doing abjectly (Neneh & Zyl, 2012). Thus, SMEs can prosper and decrease employee fraud with the help of an efficient internal control system. But many small businesses are just run by the owners, with maybe one or two executives and a limited number of workers who concentrate company performance over accounting and underestimate the significance of effective internal controls.

This is due to the high failure rate of Kenyan SMEs, the majority of which fold within the first three years of business. According to historical data from Kenya, three out of every five businesses in the country fail during the first few months of operation. This is because Kinyua (2014) asserts that the failure rate of business entities in Kenya is steadily increasing and that small firms in Kenya are unable to expand and thrive as a result of agency problems originating from SMEs owners and employees.

Medium enterprises may have limited financial resources and personnel compared to larger firms. This limitation can hinder their ability to invest in sophisticated internal control systems and hire specialized staff dedicated to internal controls.

As medium enterprises grow, their operations often become more complex. This complexity can make it challenging to design internal controls that adequately address all areas of the business without becoming overly burdensome or bureaucratic.

Implementing robust internal controls often requires changes in processes and workflows. Employees may resist these changes due to fear of additional work, perceived loss of autonomy, or scepticism about the benefits of the new controls.

Small and medium enterprise (SME) owners and managers may not always have a strong understanding of internal controls and their importance. They might lack awareness of best practices or the expertise needed to design and implement effective controls.

Medium enterprises may operate in multiple locations or have diverse business units. Ensuring consistent application of internal controls across different locations or business units can be challenging, particularly without centralized oversight.

Many SMEs may not have access to advanced technology solutions that facilitate automated monitoring and enforcement of internal controls. This can lead to manual processes that are more prone to errors or inconsistencies.

SMEs often face the dilemma of balancing the cost of implementing internal controls with the expected benefits. They may struggle to justify investments in internal controls when resources are limited and immediate returns are not always apparent.

Depending on the industry and regulatory environment, medium enterprises may be subject to various compliance requirements related to internal controls. Meeting these requirements can be resource-intensive and complex.

SMEs may be more vulnerable to human error and fraud due to less rigorous control environments. Implementing controls to mitigate these risks without imposing excessive administrative burdens can be challenging.

Once internal controls are implemented, maintaining their effectiveness over time requires ongoing monitoring, evaluation, and adaptation to changes in the business environment. This sustainability aspect can be difficult for SMEs to manage consistently.

## **2.5 The solutions to key challenges and barriers faced by medium enterprises in implementing and maintaining effective internal control systems**

SMEs can improve internal controls by managing their staff, their business, information, and technology more efficiently. SMEs can strengthen the company's supervision operations, improve management control, and improve the internal environment, internal information system, and internal communication. Small companies can increase risk awareness and make control mechanisms a recurring theme. For smaller businesses, control means being creative. Small businesses can implement measures for internal control by giving their staff members a code of conduct. The defining of responsibilities and the division of duties are further internal control principles. Limited access to funds or assets comes next, and petty cash limits are set after that. Cost or benefit analysis, employee bonding, staff rotation, external audit, and transaction independent check are examples of physical protection types of assets. Job rotation, record review, and documentation are all included in the segregation of duties. Leaders in business should make sure that internal control standards are followed.

Internal controls play a critical role in reducing the likelihood of fraud and errors. While not all fraud can be stopped, a good number of common-sense internal controls can be put in place to discourage most fraud that occurs in small organizations. Other internal control methods that SMEs can implement include having the owner sign all checks by themselves, reviewing bank statements online, and storing the check stock in a secured drawer (Robbins, 2012). It is recommended that SMEs approve supplier invoices, possess sufficient understanding of the accounting software, and regularly evaluate the bank

reconciliation statement, paying particular attention to the outstanding items (Robbins, 2012). SMEs are prone to mistakes and fraud.

Effective risk management, internal controls, and corporate governance are the cornerstones of thriving, long-lasting businesses. An audit manual is necessary for an internal control function. This manual contains organization-specific standards, principles, and procedures that must be adhered to when implementing the system for internal control. Before each employee is given a responsibility, they must be informed of two things: required vacation time and work rotation. Additional advantageous elements encompass redundant personnel for associated tasks, personnel capable of cross-referencing documentation, accuracy in check writing, payroll processing and retrieval, and cash handling.

Implementing internal controls correctly would enable company executives to use more productive and successful methods of completing tasks. In situations where there are restrictions on access to accounting software, efficient internal oversight should guarantee the formation of user IDs and passwords that provide restricted access and are periodically changed. The company leaders have the authority to assign user IDs and create access rights. Executives at companies need to make sure that there is an offshore and local system backup (Tysiac, 2012). Certain internal control actions can address cash, payroll, inventory, travel, fleet expenses, accounts receivable, write-offs, information and communication, and other financial operations in small and medium-sized enterprises (SMEs) (Tysiac, 2012). Thus, effective internal control is essential to SMEs' success.

The program must also be subject to internal control. Software controls cover the appropriate procurement, setup, and protection of operating systems, utilities, telecommunications, safety, database management, and system software. One essential element of internal control is the division of labor among various employees. SMEs have greater fraud rates as a result of inadequate internal controls. When putting the internal control system into place, the company owner

must show best practices, appropriate staff training, and process improvement where needed. Both automated and manual procedures are governed by appropriate internal control mechanisms (Johnston & Spencer, 2011). One component or crucial component of the internal control process is the segregation of duties.

## **2.5 Conclusion**

The literature research leads to the conclusion that internal control systems have a major impact on medium-sized businesses' financial performance. The organization's overall financial health, risk management, and operational efficiency can all be enhanced by these systems' efficacy. Internal controls, when appropriately put into place and overseen, can assist medium-sized businesses in meeting their financial goals and boosting stakeholder trust in the company's operations.

## CHAPTER THREE

### RESEARCH METHODOLOGY

#### **3.0 Introduction**

The researcher's techniques and tools for gathering and analysing data are presented in this chapter. Kothari (2014) describes methodology as a process used to address the research topic in a methodical manner. In this, we examine a number of approaches that a researcher typically takes when researching his research problem and the reasoning behind them.

The research design, study population, area of study, sample size selection, sampling strategies, data sources, measurement levels, data collection tools, data collection process, data quality control, and data presentation and analysis will all be included in the methodology.

#### **3.1 Research design**

A cross-sectional survey research design was used for this investigation. Information can be gathered by surveys from sizable population samples. Additionally, they are well-suited to collect demographic information that characterizes the makeup of the sample (McIntyre, 1999). According to Bell (1996), surveys are easy to construct and run, offer a wide range of variable types and numbers for study, and facilitate generalizations with reasonable ease. But surveys don't give precise measures; they just give estimations of the actual population. Dillman & Salant, 1994.

### **3.2 Area of this study**

The survey was carried out in businesses in the centre of Mukono town. Due to the fact that the company was a well-established medium enterprise, this was done.

### **3.3 Study Population**

A population is a sizable group of people from which a subset is chosen for further investigation. Top management, internal and external auditors, senior and middle staff (operational staff), and a small number of clients were identified as part of the research population. The study's target population was thirty, and its data came from this group. This was chosen and put to use in order to gather accurate and trustworthy data. Consultation was limited to individuals deemed competent in providing pertinent information. The researcher set out to determine how an automated accounting system affected the efficacy and efficiency of the auditing process, as well as any advantages or disadvantages this system would have over a manual one.

### **3.4 Sample Size Selection**

The number of units or individuals from which the researcher plans to gather data or information is the sample size, according to Evans et al. (2000). The researcher will utilize the following mathematical formula, provided by Tora Yamane, to estimate the sample size for this investigation.

Where N is the total number of respondents.

E is the degree of confidence.

N= 25 responders

N =

N=

### **3.5 Sampling Techniques**

In the sample size, Selective and purposeful sample was used to pick out the top management, internal auditors and middle staff (operational staff). These selected individuals were interviewed about the operations in their workplaces. With the information collected, it was proved to be useful in analysing the validity of the research problem.

### **3.6 Sources of data**

The researcher employed primary as well as secondary data types. First-hand and newly gathered data are referred to as primary data. The researcher used a questionnaire to collect this data for the first time. Secondary data is information that has already been gathered and examined by another party, usually for a different objective than the one at hand. Secondary data were gathered during the document evaluation process. A variety of reports as well as published and unpublished documents were reviewed. Data came from a review of a number of documents, some of which were sourced from the relevant document of the researchers' interest. These documents included an audited report, financial regulations, and an accounting handbook.

### **3.7 Measurement levels**

The measurement's level ought to be trustworthy and legitimate. There are four different kinds of measuring levels: nominal, interval, ratio, and ordinal. The metric is ranked according to importance using an ordinal scale. Only the names or designations of distinct units or groups are measured on a nominal scale. Such

values are measured using an ordinal scale, which does not specify the interval sizes, but rather in terms of more or less, greater or smaller. These values are measured using an interval scale, which has an artificial zero point that is established without denoting nothing at all. The values are measured in terms of equal intervals or degrees of difference. With an absolute zero point, a ratio scale measures in terms of equal intervals. Gender and educational attainment will be measured on a nominal scale.

When asked to rate your level of sentiment on a 5–1 scale for a particular subject, it is recognizable. The following categories of responses were included in the five-point scale that was employed: 4 = Agree, 5 = Strongly Agree 2 disagree, 3 are unsure or neutral, and 1 are strongly

Respondents were asked to rank their opinion on a scale from strongly disagree to strongly agree.

### **3.8 Data collection instruments**

The study was guided by the following research tools:

### **3.9 Questionnaire**

Self-administered questionnaires were distributed to a sample of medium enterprises in and around Mukono town. The questionnaires were designed to assess the impact of internal control systems on the financial performance of medium.

### **3.10 Procedure of Data Collection**

Prior to doing the research, the researcher ethically got an introduction letter from the dean of Uganda Christian University's faculty of business and administration. A letter of consent was received by the researcher to carry out the investigation. Internal auditors, senior/middle operational workers, and top management all received questionnaires from the researcher. Surveys were used to get this data in 2018. The respondents were also told by the researcher that complete secrecy was guaranteed and that the questionnaire was solely academic in nature. Since the data used here has been anonymized, specific responders cannot be identified from it.

#### **3.10.1 Quality/ Error control**

Validity is defined as "the degree of correspondence between explanation given for phenomena and world facts" by McMillan and Schumacher (2006). Pre-testing the questionnaires allowed for the establishment of their validity. Pre-testing assisted in estimating the amount of time required to complete the questionnaires as well as the questions' applicability and precision in measuring the subject of the study. Five respondents who were part of the study population but not the sample were given the pretest. Each question on the questionnaire was examined carefully, and any that were deemed unnecessary were taken out of the actual data collection tool. Errors were found and the instrument was modified with the assistance of field data and the researcher's perspective.

#### **3.10.2 Reliability**

According to Mugenda (2003), dependability is the constancy of the outcome a research tool yields following multiple trials. Prior to giving the exam to respondents who weren't members of the bank's sample staff, this instrument

was pre-tested for dependability. Five essential individuals were utilized, including operational staff members who are not included in the sample group. The questions were changed based on their answers.

### **3.11 Data presentation and analysis**

#### **3.11.1 Quantitative Data Analysis**

Version 20 of the Statistical Package for Social Sciences (SPSS) was used to evaluate the data that had been gathered. The data were shown in a table form. To describe the primary features of the research variables and information were analysed using descriptive statistics. The researcher chose the previously mentioned techniques of data presentation and analysis since they are comprehensible and readily usable. Descriptive and illustrative statistics, including mean and standard deviation frequencies, were used in the data analysis. Additionally, Excel was utilized for basic calculations.

# **CHAPTER FOUR**

## **PRESENTATION, ANALYSIS AND INTERPRETATION OF THE RESULTS.**

### **4.0 Introduction**

The research questions that have guided the study's methodology are used to elaborate on the findings, analysis, and interpretation of the findings in this chapter. The demographic results on the characteristics of the respondents are presented in Section 4.1, and the results regarding the effects of internal control systems on the financial performance of medium-sized businesses are presented in Section 4.2. The research paper's third section goes into further detail about the relationship between internal control systems and financial performance. Section 4.4 lists a few challenges related to internal control system implementation and maintenance.

### **4.1 Demographic characteristics of respondent**

This subsection presents results on the demographic characteristics of the respondents who participated in this research organized by i) Response Rate, ii) Age brackets, and iii) level of education.

#### **4.1.1 Response Rate**

Detailed questionnaires were designed and distributed to establish the impact of internal control system on the financial performance of medium enterprises in and around Mukono.

**Table 1 Response Rates**

<b>Details</b>	<b>Frequency</b>	<b>Percentage</b>
Responded	15	60
Did not respond	10	40
<b>Total</b>	<b>25</b>	<b>100</b>

Source: Primary Data

The study's response rate is displayed in the above table. Out of the 25 respondents in the target group, 15 responded, accounting for 60% of the response rate. The remaining 10 respondents, or 40% of the sample size, did not participate in the study. According to the research criteria, 60% of responses are required to accurately reflect the study population rate.

#### **4.1.2 Age Bracket of respondents**

*Table 2: Age bracket of respondents*

<b>Details</b>	<b>Number</b>	<b>Percentage</b>
21-30	7	47
31-40	7	47
41-50	0	0
Above 50	1	6
<b>Total</b>	<b>15</b>	<b>100</b>

Source: Primary Data

Seven respondents, or 47% of the sample size, were in the 21–30 and 31–40 age groups out of a total of 15. A single individual, accounting for 6% of the sample, was over the age of 50. These results reveal that most of the responders were young adults in the beneath-40 age range.

#### 4.1.3 Education level of the respondent

The below presents the results of the analysis of the education levels of the respondents.

**Table 3: Educational level of the respondent**

<b>Details</b>	<b>Number</b>	<b>Percentage</b>
Primary level	0	0
Secondary level	2	13.33
Certificate level	1	6.7
Diploma level	1	6.7
Bachelor’s level	10	66.7
Masters level	1	6.7
<b>Total</b>	<b>15</b>	<b>100</b>

Source: Primary Data

Out of the fifteen respondents, two individuals had stopped at secondary level reflecting a 13% response rate. One more individuals had stopped at certificate level reflecting a 6.7% response rate and one individual had stopped at diploma level reflecting a 6.7% response rate, ten individuals had stopped at bachelor’s level reflecting a 66.7%, one individual had completed up to masters level reflecting a 6.7% response rate. The above results indicate that the majority of the individuals who work in medium enterprises have Bachelors’ Degrees (66.7%)

and these are followed by the individuals have secondary school certificates (13.33).

#### 4.1.4 Marital status of the respondent

The table below presents the results of the analysis of the marital status of the respondents.

**Table 4: marital status of the respondent**

<b>Details</b>	<b>Number</b>	<b>Percentage</b>
Single	6	40
Married	7	46.7
Widow	0	0
Widower	0	0
Divorced	2	13.3
<b>Total</b>	<b>15</b>	<b>100</b>

Source: Primary Data

Out of the fifteen respondents, six individuals were single reflecting a 40% response rate. Seven individuals were married reflecting a 46.7% response rate and two individuals were divorced reflecting a 13.3% response rate.

The results are arranged in the next part according to the three research objectives. The data came from surveys that were given to different businesses in and around Mukono town. In order to analyze the questionnaire replies, codes were assigned, with 1 denoting severely disagree, 2 disagree, 3 neutral, 4 agree, and 5 strongly agree.

## 4.2 The Impact of Internal Control Systems on Financial Performance

The first objective of this study was to examine the impact of internal control systems on the financial performance of medium enterprises. The table below presents the analysis of the findings from the questionnaire on this topic.

*Table 3: Impact of Internal Control Systems on financial Performance*

Number	Question	Mean
1.	The internal control systems contribute to achieving our enterprise's strategic goals.	4.4
2.	Effective internal control systems improve the overall performance of our enterprise.	4.4
3.	The internal control systems in our enterprise significantly enhance operational efficiency.	4.5
<b>The average mean of the responses on the Impact of Internal Control Systems on Performance</b>		<b>4.4</b>

Following is the interpretation of these results.

### 4.2.1 The internal control systems contribution to achieving the enterprise's strategic goals

If the respondent's employer's internal control systems helped the organization achieve its strategic goals, was the subject of another survey question. All fifteen respondents, on average, agreed that internal control systems greatly increase organizational efficiency, as indicated by the average response to this question (4.4).

This finding aligns with the literature reviewed, which indicated that internal control systems enable organizations to have accurate financial reporting and reliable financial management, allowing them to make informed decisions, secure financing, and invest in growth opportunities (Doyle & McVay, 2007).

#### **4.2.2 The internal control systems improve overall performance**

The respondents were asked whether their company's internal control systems help improve the enterprise's overall performance. The Analysis of the responses to this question in the table above produced a mean of 4.4, indicating that, on average, all fifteen respondents agreed that internal control systems help improve the enterprise's overall performance.

This finding aligns with the literature reviewed, which indicated that internal control systems enable organizations to have accurate financial reporting and reliable financial management, allowing them to make informed decisions, secure financing, and invest in growth opportunities (Doyle & McVay, 2007).

This result is consistent with the literature review, which found that internal control systems aid in the identification and avertance of fraudulent activity, shielding businesses from monetary losses and reputational harm. It was also discovered that the internal control systems had made sure that frequent audits were conducted to simplify operations and eliminate duplications and inefficiencies. This enhanced resource management, sped up procedures, and increased overall productivity.

#### **4.2.3 The internal control systems significantly enhance operational efficiency**

Thus, the inquiry centred on whether their organizations' internal control frameworks markedly improve operational effectiveness. After this question's responses were analysed, a mean of 4.5 was determined. Consequently, all fifteen respondents strongly agreed, on average, that internal control systems help their organization achieve its strategic goals, as indicated by a mean score of 4.5, which is closer to 5 = Strongly Agree.

This finding aligns with the literature reviewed, which indicated that internal control systems enable organizations to have accurate financial reporting and reliable financial management, allowing them to make informed decisions, secure financing, and invest in growth opportunities (Doyle & McVay, 2007).

According to the literature analysed for this study, internal control systems help identify bottlenecks and optimize processes, which makes operations go more quickly and smoothly and helps workers do their tasks more quickly and effectively. The literature also showed that the internal control system of the organization has helped to provide accurate resource monitoring and proper management, which improves staff performance and resource utilization. Systems of internal organizational control lower the rate of resource waste as well.

In conclusion, the overall results indicate a mean average of 4.4 for all the three responses indicating that all responses were agreeing that internal control systems impact the financial performance of medium enterprises.

### **4.3 The relationship between internal control systems and operational efficiency in medium enterprises**

The relationship between operational efficiency and internal control systems in medium-sized businesses was another goal of this study. An analysis of the results from the questionnaire on this topic is shown in the following table.

*Table 2: The relationship between internal control systems and operational efficiency*

<b>Number</b>	<b>Question</b>	<b>Mean</b>
1.	There is a positive correlation between internal control systems and financial performance of the enterprise	4.4
2.	Strong Internal Control Systems are associated with better financial outcomes of the enterprise	4.3
3.	Financial Performance improved due to the implementation of robust Internal Control Systems.	3.9
<b>The average mean of the relationship between internal control systems and operational efficiency</b>		<b>4.2</b>

Following is the interpretation of these results.

#### **4.3.1 A positive correlation between the internal control systems and the financial performance**

Was there a beneficial relationship between financial performance and internal control systems? The average score for the answers to this question was 4.4. This indicates that, on average, each of the fifteen responding companies acknowledged the link between improved financial performance and internal control systems.

The above results correspond with the existing literature which says that internal control systems improve the accuracy and reliability of financial reporting through enhancing the credibility of financial statements leading to better investment decisions and potentially lower borrowing costs which positively impact financial performance (Jain & Rezaee, 2006).

In addition internal control systems ensure that the organisation complies with regulatory requirements to avoid fines and legal costs which thus protects the organisation financial resources and maintains the organisation's financial stability.

#### **4.3.2 Strong internal control systems are associated with better financial outcomes in the enterprise.**

The respondents were asked whether strong internal control systems are associated with better financial outcomes in the enterprise. The analysis of the responses to this question produced a mean of 4.3, indicating that, on average, all fifteen respondents agreed that strong internal control systems are associated with better financial outcomes in the enterprise.

The above results align with the already existing literature that internal control systems implemented by the enterprise ensure that financial data is accurate and complete. This reliability enhances the quality of financial statements, attracts investors and creditors and potentially lowers the cost of capital (Sharma & Iselin, 2012).

In addition internal control systems implemented by the enterprise ensure well-designed controls, streamline business processes, reduce inefficiencies, and optimize resource use. This leads to cost savings and improved productivity which contributes to a better financial performance.

#### **4.3.3 Financial performance has improved due to the implementation of robust internal control systems**

The purpose of the inquiry was to ascertain whether the installation of strong internal control measures led to an improvement in the financial performance. An average of 3.9 was obtained from the analysis of the replies to this question, indicating that, on average, all of the respondents believed that the establishment of strong internal control systems led to an improvement in the financial performance.

The above findings align with the already existing literature where internal controls systems ensure identification and mitigation of financial risks early so that the organisation could avoid potential losses and financial instability (Sharma & Iselin, 2012).

In addition internal controls systems ensure compliance with regulations and standards therefore avoiding penalties and fostering a positive reputation. The internal controls systems ensure that there is minimized risk of fraud and financial misstatements therefore reduces the likelihood of costly errors and legal issues.

Overall, the results show that there is a good correlation between operational efficiency in medium-sized businesses and internal control systems, with an average score of 4.2 across all three responses.

#### **4.4 The key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems**

The study's third goal was to list some of the main obstacles and problems that medium-sized businesses face when setting up and maintaining effective internal controls. The table below analyses and presents the results under this subject.

*Table 3: The key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems*

<b>Number</b>	<b>Question</b>	<b>Mean</b>
1.	Enterprise faces significant challenges in implementing internal control systems	2.9
2.	Lack of resources is a major barrier to maintaining effective internal control systems in the enterprise	3.5
3.	Training and expertise are insufficient to support the effective implementation of internal control systems	2.5
<b>The average mean of the responses on the key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems.</b>		<b>3.0</b>

Following is the interpretation of these results.

#### **4.4.1 Enterprise faces significant challenges in implementing internal control systems.**

When asked if establishing internal control systems presents substantial challenges for enterprises, the respondents gave their answers. An average of 2.9 was obtained from the analysis of the replies to this question, indicating that fifteen respondents were either neutral or unsure about whether the organization confronts substantial problems in establishing internal control systems.

The above results does not correspond to the already existing literature that medium enterprise face inadequate financial and human resources which make it difficult for them to invest in comprehensive control system or hire specialized staff. This finding indicates that the respondents did not want to show a bad image of their medium enterprises.

#### **4.4.2 Lack of resources is a major barrier to maintaining effective internal control systems in the enterprise.**

The question is, "Lack of resources is a major barrier to maintaining effective internal control systems in the enterprise." The average mean of the fifteen answers to this question's analysis was 3.5, meaning that, on average, they all agreed that a lack of resources makes it more difficult for an organization to maintain efficient internal control systems..

The above findings align with the already existing literature that the enterprises often have limited budgets, making it difficult to allocate funds for developing and maintaining comprehensive internal control systems and costs for other items that help control operations such as software, training and external audits (Hayes, et al., 2005).

#### **4.4.3 Training and expertise are insufficient to support the effective implementation of internal control systems**

The purpose of the survey was to find out if the respondents' knowledge and experience had been inadequate to enable the successful installation of internal control systems. An average score of 2.5 was obtained from the analysis of the replies to this question, indicating that fifteen respondents did not, on average, believe that the internal control systems had not been implemented effectively due to a lack of training or experience.

The above results does not correspond to the already existing literature that training and expertise alone cannot address a lack of organisational commitment or support. Without buy-in from the top management and staff, well trained employees struggled to implement internal controls systems effectively (Jensen & Payne, 2003).

In conclusion, the overall results indicate a mean average of 3.0 for all the responses indicating that all respondents were neutral or not sure about the key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems.

# CHAPTER FIVE

## DISCUSSION OF FINDINGS, CONCLUSION, AND RECOMMENDATIONS

### 5.0 Introduction

The results of Chapter 4 are put together in this chapter. The researcher highlights the chapter by providing a conclusion and recommendation based on the study's objectives. The purpose of the study was to determine how medium-sized businesses' internal control systems affected their financial performance. This case study covered 15 medium-sized Mukono businesses, including superstores, gas stations, hardware stores, and pharmacies. A few of the research's goals are to assess the impact of internal control systems on medium-sized businesses' operations, evaluate the connection between internal control systems and financial performance in these businesses, and pinpoint the main obstacles and challenges that medium-sized businesses must overcome to implement and maintain efficient internal control systems.

### 5.1 Summary of findings

The following table highlights the summary of the findings of the research .

*Table 4 Summary of the research findings to the objectives*

<b>Number</b>	<b>Objective</b>	<b>Results</b>
1	To examine the impact of internal control systems on medium enterprise performance,	The average mean of the responses on the Impact of

Number	Objective	Results
		Internal Control Systems on financial Performance was 4.4.
2	To examine the relationship between internal control systems and financial performance in medium enterprises	The average mean of the responses on the relationship between internal control systems and operational efficiency was 4.4.
3	To examine the major challenges and barriers that medium enterprises face when implementing and maintaining effective internal control systems	The average mean of the responses on the key challenges and barriers medium enterprises face in implementing and maintaining effective internal control systems was 3.0.

### **5.1.1 The impact of internal control system on the financial performance of medium enterprises**

The findings indicated that the internal control system have a positive impact on the financial performance of medium enterprises. This finding is supported by the following reasons.

**Fraud Prevention and Detection:** Robust internal controls guard assets and lessen financial loss by preventing and identifying fraudulent activity. They guarantee that accounts are reliable and precise, which is crucial for drawing in lenders or investors and for making educated decisions about commercial affairs. Internal controls make the best use of available resources to increase operational efficiency, which may ultimately result in lower expenses and better financial results.

**Compliance with Regulations:** Proper controls enable medium-sized businesses to comply with laws and regulations, avoiding legal penalties and encouraging stakeholder trust.

**Risk Management:** Internal controls assist in identifying and mitigating risks, resulting in more steady financial performance and protection against financial losses.

### **5.1.2 The relationship between internal control systems and financial performance in medium enterprises**

The findings indicated that there is a positive relationship between internal control systems and financial performance in medium enterprises. This finding is supported by the following reasons.

By strengthening the credibility of their financial statements, internal control systems improve the informativeness and dependability of reporting. This influences financial performance by facilitating better investment choices and lowering borrowing costs.

In addition, internal control systems ensure that the organisation complies with regulatory requirements to avoid fines and legal costs which thus protects the organisation financial resources and maintains the organisation's financial stability.

### **5.3 Challenges in implementation and maintaining internal control systems on the financial performance of medium enterprises**

The findings indicated that the respondents were not sure or were neutral about the challenges medium face in implementing and maintaining internal control

systems. This finding is probably because the respondents did not want to show a negative image of their companies.

### **5.3 Recommendations**

The following are the recommendations for implementation by Medium Enterprises on strengthening internal control systems based on the results of this research.

**Increased Accuracy and Reliability:** it is recommended that medium enterprises should implement robust internal controls which help to lessen errors and fraud by guaranteeing that financial data is accurate and reliable. This will result into better financial performance and better-informed decision-making.

**Improved Compliance:** it is recommended that medium enterprises should implement strong internal controls which enable them to comply with regulations and standards, avoiding fines and legal concerns. Compliance promotes financial stability and improves the company's reputation.

**Effective Resource Management:** it is recommended that medium enterprises should set up good controls to streamline procedures, lower waste and reduce operational inefficiencies. This optimizes resource utilisation and can lead to cost reductions, which improves financial performance.

**Risk Management:** it is recommended that medium enterprises should implement internal controls to detect and reduce threats to financial performance, such as financial misstatements or fraud. Managing these risks safeguards the assets and helps improve financial performance.

**Improved Accountability:** it is recommended that employees of medium enterprises should follow internal control procedures and be more accountable, which can improve output and decrease financial disparities thus improving financial performance.

**Financial Transparency:** it is recommended that medium enterprises should maintain clear and accurate financial information, set up transparent internal controls which help investors, creditors, and stakeholders have more trust in the company. This can lead to easier access to capital and investment opportunities thus improving financial performance.

**Frequent Monitoring and Review:** it is recommended that medium enterprises should closely monitor internal controls and ensure that they continue to function well and adjust to changes in the business environment so that financial performance can be sustained over time.

## **5.4 Conclusion**

In summary, the impact of internal control systems on the financial performance of medium-sized businesses is significant and diverse. Internal controls can, nevertheless, have a number of benefits when implemented properly, such as improving the financial reports' veracity and accuracy, possibly ensuring compliance with applicable laws, and, most importantly, promoting effective resource management. Each of these makes a significant contribution to ensuring the areas of financial transparency, accountability, and risk management. Medium-sized businesses might be able to safeguard their assets and boost operational efficiency by doing this. By implementing suitable internal control systems in an appropriately structured way, it will also aid in attracting investor confidence in them. This would suggest better financial performance in the direction of long-term sustainability, the ultimate goal.

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**APPENDIX**  
**QUESTIONNAIRE.**

**UGANDA CHRISTIAN UNIVERSITY**

**School of Business**

I am Ngabirano Rodney a student of Uganda Christian University conducting a research study on “Internal Control System On The Performance Of Medium Enterprises “as a requirement for the award of Bachelors of science in accounting and finance at Uganda Christian University.

I am kindly requesting you to assist me in this study by answering the following questions. I assure you that your information will be treated with utmost confidentiality.

**SECTION A: Demographic Data**

Please tick (✓) in the appropriate box  as the most agreed answer to the following statements.

1. Gender of the respondent.

Male

Female

2. Age group of the respondent.

21-30 years

31-40 years

41-50 years

above 50 years

3. Marital status of the respondent.

Single

Married

Widow

Widower

Divorced

4. Education level of the respondent.

Primary level

Secondary level

Certificate level

Diploma level

Bachelor's level

Masters Level

Others

specify.....

.....

Questionnaire: Assessing the Impact of Internal Control Systems on Medium Enterprises

Please rate the following statements on a scale of 1 to 5, where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree, and 5 = Strongly Agree.

**Section B: Impact of Internal Control Systems on Financial Performance**

Details	1	2	3	4	5
The internal control systems contribute to achieving our enterprise's strategic goals					
Effective internal control systems improve the overall performance of our enterprise					
The internal control systems in our enterprise significantly enhance operational efficiency					

**Section C: Relationship between Internal Control System and Financial Performance**

Details	1	2	3	4	5
There is a positive correlation between our internal control systems and our revenue.					
There is a positive correlation between our internal control systems and our liabilities					
There is a positive correlation between our internal control systems and our profitability					

**Section D: Challenges in Implementing and Maintaining Internal Control Systems**

Details	1	2	3	4	5
Our enterprise faces significant challenges in implementing internal control systems.					
Lack of resources is a major barrier to maintaining effective internal control systems in our enterprise					
Resistance to change within the organization hampers the effectiveness of internal control systems.					
Lack of training and expertise is a major barrier to the effective implementation of internal control systems					

Thank you

# Introductory Letter



**UGANDA CHRISTIAN  
UNIVERSITY**

A Centre of Excellence In the Heart of Africa

## SCHOOL OF BUSINESS

19<sup>th</sup> Aug, 2024

TO WHOM IT MAY CONCERN

Name: NGABIRANO RODNEY

Reg. No S21B33/094

A bachelor's student who is seeking permission from your office to collect data for her dissertation titled

**THE IMPACT OF INTERNAL CONTROL SYSTEMS ON THE FINANCIAL PERFORMANCE OF MEDIUM ENTERPRISES**

We shall be grateful if you could render assistance to her in collecting the necessary data for her dissertation

The Uganda Christian University School of Business thanks you in advance

Mukisa Simon Peter  
Research coordinator



A Centre of Excellence in the Heart of Africa