



ISSN: 0975-833X

RESEARCH ARTICLE

IS INTERNAL CONTROL SYSTEM AN EFFECTIVE TOOL IN FINANCIAL MANAGEMENT? A PRACTICAL EXPERIENCE FROM SMALL AND MEDIUM ENTERPRISES IN ELDORET MUNICIPALITY, KENYA

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ARTICLE INFO

Article History:

Received 27th April, 2015
Received in revised form
15th May, 2015
Accepted 28th June, 2015
Published online 31st July, 2015

Key words:

Internal Controls System,
Financial Management,
Small,
Medium Enterprises,
SME.

ABSTRACT

Small and Medium Enterprises (SMEs) constitute the engine of economic growth in developing countries. They are the source of employment to millions of people, technological innovations and also help in reducing poverty in developing countries. In Kenya, SMEs created 440,400 jobs in the year 2010 and also accounted for 18.4% of the gross domestic product (GDP) in 2011. The Kenya government has offered great support (both direct and indirect) to SMEs in line with the nation's goal to become a middle level income economy by the year 2030. Despite their immense contribution to economic growth, SMEs in Kenya continually face challenges, including mainly lack of planning, improper financing and poor management. This has been the main cause of over 60% of the small enterprises failing each year in Kenya. Finance is the backbone for any businesses, whether small or large. As such, systems need be put in place to ensure that they are effectively managed. Guided by Systems and Competitive Advantage Theories, the study sought to establish the internal control systems (ICS) in place, how they are being evaluated, challenges faced by SMEs while implementing these systems and if they are effective tools in their financial management. The study targeted 21,320 SMEs in Eldoret Municipality but sampled 100 using the Taro Yamane's 1967 table. Questionnaires were used to collect data which was then analyzed using descriptive statistics. From the findings, the ICS were being implemented by SMEs in Eldoret Municipality although no evaluation was being done. Furthermore, the ICS was found to be an effective tool in financial management, although many of the respondents said they lacked the knowledge about ICS while developing and implementing it. The study recommends that further research should be conducted on ways to evaluate the ICS and address the challenges related to ICS faced by SMEs.

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Citation: Peninah Jepkoge Tanui, Sarah Chumba and Jared Bogonko Bitange, 2015. "Is internal control system an effective tool in financial management? a practical experience from small and medium enterprises in Eldoret municipality, Kenya", *International Journal of Current Research*, 7, (7), 18673-18679.

INTRODUCTION

Small and Medium Enterprises (SMEs) play a major role in the economies of both developed and developing countries. They constitute the engine of growth for developing countries. In particular, SMEs play an important role in creating employment opportunities to millions of especially young people, as a source of technological innovation to create new products and in poverty reduction. SMEs comprise over 90% of Africa's business operations and contribute to over 50% of Africa's employment (Okafor, 2006). In Ghana, SMEs account for 70 per cent of the country's gross domestic product (GDP) and 92 per cent of its businesses.

They also make up 91% of formalized businesses in South Africa and 70 per cent of the manufacturing sector in Nigeria (Frimpong, 2013). According to Economic Survey (Republic of Kenya, 2011), in the year 2010, 503,000 jobs were created in Kenya of which 80.6% or 440,400 were in the SME sector. The SME sector accounts for 18.4% of the country's GDP (Republic of Kenya, 2011). SMEs play a very important role in furthering growth, innovation and prosperity (Dalberg, 2011). The leading international aid agency, the World Bank Group (WBG), has boosted the growth of SMEs in the developing economies by offering both direct and indirect support. In March 2000, WBG created a new SME department to partner with various parts of the Bank's group in providing better assistance to small businesses. According to World Bank statistics (2002, 2004), 80% of its programmes involve financial assistance to SMEs and 20% involve indirect support

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such as technical assistance for both SMEs and institutions supporting them. The WBG has been most active in Africa in terms of the number of activities, with 296 targeted SME support activities valued at \$6.5 billion (World Bank Group, 2013). It is clear that the WBG understands the economic value of SMEs in Africa. Bearing this in mind, it is important to put in place measures to ensure the finances of SMEs are well managed so as to continue providing essential services to citizens in developing countries.

Kenya seeks to become a middle income level economy by the year 2030. In its blue print, the Kenya Vision 2030, the country aims to strengthen SMEs to become the key industries of current and future times. Being a member of the East African Community (EAC), Kenya has shown great commitment to improve infrastructure in the region. In May 2014, for example, Kenya and China signed a partnership agreement for the construction of a standard gauge rail way line which will reduce costs of transport and costs of doing business across the EAC region. This move was also meant to open up Kenya as a competitive business hub for the East African region and beyond. The Kenya government is further committed to establishing a duty-free zone to enhance business activities within the Eastern Africa region in order to actualize its desire 'to bring Dubai to Kenya'.

Statement of the Problem

SMEs face a number of challenges which continue to hinder them from blossoming into strong units of business and national economic development in Kenya. Longenecker *et al.* (2006) identify the major causes of the failure of small businesses as lack of planning, improper financing and poor management. Furthermore, competition from big firms, fluctuation of the economy, unfavourable government laws and policies are among the common factors that impede the flourishing of these sectors. According to the Kenya National Bureau of Statistics (2006), over 60% of the small enterprises are bound to fail each year in Kenya. This failure rate is alarming considering the health of an economy as a whole has been found to have a strong relationship with the health and nature of the SMEs (Mead, 1994). Regardless of their high failure rates, make the contribution of SMEs in Kenya to the entire economy cannot be overlooked (Mbogo, 2011). Of all the challenges noted above, lack of access to credit is the most pressing. Many financial institutions are still reluctant to lend money to SMEs because in most cases, the SME entrepreneurs lack the necessary collateral; others do not have adequately compiled financial records and accounts and low level of technical and management skills which discourage lenders (Wanjohi & Mugure, 2008). To meet these requirements, SMEs need to put in place effective internal control systems (ICS) to assist them to streamline their internal issues and preparing financial records and accounts that enhance effectiveness in their businesses.

Many young entrepreneurs find it hard to make investments in Kenya due to limited credit for capital. Those who manage to invest do so at the sacrifice of other consumption needs. It is for this very reason that the proper management of SMEs cannot be gainsaid. Unfortunately, majority of the

entrepreneurs in the SME sector do not possess the requisite financial skills to manage their enterprise finances appropriately (KNBS, 2011). Internal control is a means by which resources of the SMEs are directed, monitored and measured. It plays an important role in preventing and detecting fraud and protecting the physical and intangible resources; moreover it leads to high efficiency of business operations (Bogonko & Ndiwa, 2014). Therefore without strong ICS to monitor and run their businesses, SMEs are constantly faced with the prospect of bankruptcy (Sampson, 1999). Indeed, ICS is very important for any business, regardless of the size, to ensure that the finances are well managed.

On 1st July 2014, there were 33,796 businesses in Eldoret Municipality (Uasin Gishu County Government, 2014). SMEs in this list formed the lion share of the total businesses since they accounted for 63.08% (21,320 SMEs). Since the enactment of devolved government system in March 2013, in line with Kenya's constitution promulgated in 2010, many opportunities for SMEs were generated as most County governments established themselves locally. As such, it was expected that SMEs would flourish in the new system. Bearing this in mind, the study sought to establish the effectiveness of ICS in financial management of the SMEs in Eldoret Municipality. Specifically, the study sought to identify the internal control systems put in place by SMEs; determine how those internal control systems are being evaluated by SMEs; establish the challenges faced by SMEs while trying to implement internal control systems, and determine if ICS was effective in the management of finances among SMEs in Eldoret Municipality.

The study will help SMEs to identify suitable ICS to guarantee effective financial management in their operations. It will also help the County government to sensitize SMEs on the benefits of accessing finances and putting control measure to manage them properly to avoid misappropriation of funds.

The conceptual framework of the study was based on a number of issues. The mechanisms of internal control system constituted the independent variable of the study. It was comprised of segregation of duties, authorization of transactions, retention of records, supervision, physical safeguards or restrictions and processes controls.

Theoretical Framework

Systems Theory

The Systems Theory was originally propounded by Hungarian biologist Ludwig von Bertalanffy (1928). The foundation of the Theory is that all the components of an organization are interrelated, and that changing one variable does have an impact on the others. The Systems Theory, therefore, demonstrates the importance of internal control systems in an organization to enable it to manage performance with the changes in inputs and outputs. In line with this view of the Theory, SMEs must put internal control systems in place to ensure that the finances are well managed.

Competitive Advantage (CA) Theory

The theory of Competitive Advantage (CA) was propounded by Michael Porter in 1990. According to this Theory, an organization achieves competitive advantage (being ahead of its competitors) from organizational attributes such as superior skills exercised by the management, relevant resource availability and use, as well as the market position status. SMEs face a lot of competition from the large firms and thus need to develop superior skills to gain competitive edge. One of such skills is an effective internal control system that ensures that their finances are well managed.

LITERATURE REVIEW

Internal Control System (ICS)

The statement of auditing standards No. 300 defines ICS to comprise the control environment, the control procedures, all policies and procedures adopted by directors and management of an entity to assist in achieving their objectives. These include the orderly and efficient conduct of business, adherence to internal policies, safe guarding of assets, prevention and detection of frauds and/or errors, ensuring the accuracy and completeness of accounting data, records and the timely preparation of reliable financial statements.

In reference to financial management, ICS is the pillar that ensures that accurate financial records are retained, effective management of assets, liabilities, ensuring compliance with established accounting standards, laws and regulations. Internal controls have existed since ancient times such as the Egyptian civilization in which there was a dual administration, with one set of bureaucrats charged with collecting taxes and another with supervising them. Nyabwanga (2011), in a study in Kisii South District in Kenya, has established that majority of the business owners have basic education and over 57% business operators hardly attend any business training programmes. Studies by Bowen *et al.* (2009), Atieno (2009) and Fidler and Webster (1996) identify a number of the challenges facing SMEs in Kenya. From these studies, it is clear that Kenya is in dire need of well-trained business owners capable of putting up effective systems or measures to properly manage their business finances in order to become internationally competitive and triumph over the challenges they face.

The establishment and implementation of ICS has for long been considered by many as the work of management. Being a set of control environment and procedures, ICS is a necessary and crucial part of all areas of any organisation. It is vital in ensuring compliance with the necessary requirements of business and smooth running of financial operations. Generally, most studies carried out on SMEs in Kenya have mainly focused on credit accessibility, challenges facing SMEs, causes of failure and adoption of information technology. The area of ICS among Kenya's SMEs has been greatly overlooked by researchers even though it is the underlying foundation of all other studies.

Wairegi (2011) has, for example, looked into the accounting systems in small and micro enterprises in Kenya. On the other

hand, Mugambi (2010) has examined ways of mitigating factors hindering Kenya's SMEs from accessing credit. Studies have mainly identified that lack of basic technical skills hinders many SMEs from flourishing (Nyabwanga, 2011). Bogonko and Ndiwa (2014), in a study to establish the relationship between ICS implementation and effective management of SMES in Eldoret Municipality, Kenya, have found that all constructs of ICS (control environment, control activities, risk assessment, monitoring, information and communication) have a positive relationship with operations of the SMEs.

According to Anduuru (2005), SMEs have not established elaborate systems of internal controls. Internal controls are a function of internal audit function. Small entities tend to disregard this important function whose benefits far outweigh the costs of having none (Messier, 1997). However, Putra (2009) notes that SMEs are not too small for effective internal controls because even a relatively small business needs to enforce certain internal controls.

Financial Management

Financial management is concerned primarily with financial decision-making within a business entity (Fabozzi & Peterson, 2003). Small businesses have financial management issues that are quite different from larger businesses that require new and different solutions (Ang, 1991). These unique financial management issues include agency problems, information, failure costs, taxes and transaction costs which require apt financial decisions (dividends, capital structure, capital budgeting and liquidity). Finances of small businesses need to be well managed regardless of the unique issues facing them. Ernst and Young (2011) argue that although some SMEs prepare reports, they are often incomplete and cannot give a clear picture of the financial position and profitability of the firm. SMEs need to put in place sound internal control systems to ensure their finances are properly managed.

Ondieki, Ochieng and Busaka (2013) have found that cash management is a working capital management component that contributes to a great extent on survival or failure of SMEs in Kenya. The common cash management techniques used include speeding cash collection and delayed payment of creditors. The researchers saw it wise to dwell on cash management since it is at the 'heart' of the SME operations. Small and medium scale enterprises operate in total disregard of internal control systems the result of which is of ten the mass failure of these business organizations (Were, as cited in Nyakundi *et al.*, 2014). Katuntu (as cited in Nyakundi *et al.*, 2014) adds that 90% of the business start-ups do not operate beyond the third anniversary due to lack of sound internal control systems. The views by Were and Kantutu underscore the need for SMEs to implement ICS to guarantee the success of their businesses.

Nguyen (2001) states that financial management practices (working capital management, financing, investment, financial reporting and accounting information systems) are largely ignored by SMEs. Most small and medium enterprise owners consider financial management an issue relevant only to large

companies (Wanjohi *et al.*, 2010). According to Nguyen (2001), financial management is made of fixed assets management, capital structure management, financial planning, working capital management, financial reporting and accounting information system. On the other hand, Meredith (2003) states that financial management is concerned with all areas of management (sources and uses of finance, financial implications). In all these studies by Nguyen (2001), Wanjohi (2010) and Meredith (2003), financial management components and roles have been clearly stated but there is need to determine the necessary measures to be put in place for these measures to be effective.

Nyakundi *et al.* (2014) have carried out a study in small and medium scale businesses in Kisumu City and found out that internal control systems significantly influence their financial performance. To have a competitive edge over the rest of the firms, business entities constantly carry out appraisals of their internal control systems. Therefore, the basis of superior enterprise financial performance is stronger, reliable and up-to-date systems of internal controls (Nyakundi *et al.*, 2014).

MATERIALS AND METHODS

The research used a case study research design to examine the internal control systems put in place by SMEs in Eldoret Municipality, Kenya. Eldoret is the fifth largest town in Kenya after Nairobi, Mombasa, Kisumu and Nakuru. The town is situated in Rift Valley Province, Kenya and is home to many of the legendary Kenyan athletes and some renowned farmers. The study was descriptive, non-experimental and cross-sectional and gathered a mixture of qualitative and quantitative data. The study targeted 21,320 SMEs in the Municipality. Using Taro Yamane (1967) table, the researchers selected a sample size of 100 respondents.

The data was collected using questionnaires of which the test and retest technique was used to test the validity and reliability. Out of the 100 questionnaires issued, 90 were returned. After editing and coding data, it was entered into Statistical Package for the Social Sciences (SPSS) and analysed using descriptive statistics.

RESULTS

Internal Control Systems (ICS) in Place

The study sought to establish the Internal Control Systems (ICS) put in place by SMEs in Eldoret Municipality. The results were as shown in Table 1 below.

The table below shows the results on whether or not retention of records, supervision, physical safeguards or restrictions and process controls as ICS systems existed among the SMEs in the study area.

Table 1 above shows that, according to 67.8% of the respondents, ICS exists among SMEs in Eldoret Municipality. All types of ICS do exist as well (mode = 1, which represents 'Yes'). The ICS services in places were: segregation of duties (63.3%), authorization of transactions (67.8%), retention of records (65.6%), supervision (67.48%), physical safeguards or restrictions (64.4%) and process controls ICS (64.4%).

Evaluation of Internal Control System

The study further sought to determine how the internal control system was being evaluated by SMEs in Eldoret Municipality. The results were as shown in Table 3 below.

Table 1. Existing ICS among SMEs in Eldoret Municipality

	Does the business have the ICS?	Do segregation of duties ICS exists in your business?	Do authorization of transaction ICS exist in your business?
N	Valid 90 Missing 0	90 0	90 0
Mean	1.322	1.378	1.322
Mode	1	1	1
Skewness	0.774	0.771	0.773
Std. Error of Skewness	0.254	0.254	0.254

Table 2. Existing ICS among SMEs in Eldoret Municipality

	Do retention of records ICS exists in your business?	Do supervision ICS exist in your business?	Do physical safeguards or restrictions ICS exist in your business?	Do process controls ICS exist in your business?
N	Valid 90 Missing 0	90 0	90 0	90 0
Mean	1.344	1.322	1.356	1.356
Mode	1	1	1	1
Skewness	0.664	0.774	0.614	0.614
Std. Error of Skewness	0.254	0.254	0.254	0.254

Table 3. Evaluation of ICS by the SMEs in Eldoret Municipality

	How is segregation of duties ICS evaluated?	How is authorization of transaction ICS evaluated?	How is retention of records ICS evaluated?	How is supervision ICS evaluated?	How is physical safeguards or restrictions ICS evaluated?
N	Valid 90 Missing 0	90 0	90 0	90 0	90 0
Mean	3.189	3.178	3.2	3.244	3.222
Mode	5	5	5	5	5
Skewness	0.008	0.016	-0.017	0.016	-0.047
Std. Error of Skewness	0.254	0.254	0.254	0.254	0.254

From the results in Table 3 above, the mode score (5 which represents ‘Never’) shows that the SMEs do not evaluate their ICS. The percentage scores were: for segregation of duties (44.4%), authorization of transactions (43.3%), retention of records (43.3%), supervision (44.4%), physical safeguards or restrictions (43.3%) and process controls ICS (44.4%). However, a few respondents agreed that they did the evaluation often as indicated by 30%, 30%, 27.8%, 36.7%, 24.4% and 28.9% for segregation of duties, authorization of transactions, retention of records, supervision, physical safeguards or restrictions and process controls ICS respectively.

The table below shows the findings on the tools used by SMEs in Eldoret Municipality to evaluate ICS.

As shown in Table 4, although a few SMEs used audit tool to evaluate the ICS, those not carrying out evaluation were still many (45.6%).

Table 4. Tool used by SMEs in Eldoret Municipality to Evaluate ICS

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Audits	24	26.7	26.7	26.7
	Questionnaires	13	14.4	14.4	41.1
	Observations	12	13.3	13.3	54.4
	None	41	45.6	45.6	100.0
	Total	90	100.0	100.0	

Table 5. Challenges faced by SMEs in Eldoret Municipality

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Lack of knowledge	50	55.6	55.6	55.6
	Resistance of ICS within the business	9	10.0	10.0	65.6
	Complexity of business operations	16	17.8	17.8	83.3
	Shortage of staff to implement and evaluate ICS	7	7.8	7.8	91.1
	Business owners or owners ignorance	8	8.9	8.9	100.0
	Total	90	100.0	100.0	

Table 6. The Effectiveness of ICS in Financial Management

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Effective	46	51.1	51.1	51.1
	Not effective	37	41.1	41.1	92.2
	Moderate	7	7.8	7.8	100.0
	Total	90	100.0	100.0	

Challenges faced by SMEs in Implementation of Internal Control System

The study further sought to establish the challenges faced by SMEs in Eldoret Municipality while trying to implement the ICS. The results were as shown in Table 5 below.

SMEs in Eldoret Municipality faced a number of challenges while developing and implementing ICS. These challenges included lack of knowledge on ICS (55.6%) and the complexity of business operations (17.8%). Other challenges faced included resistance to ICS within the business (10%), business owner’s ignorance (8.9%) and shortage of staff to implement and evaluate (7.8%).

Perception of ICS Effectiveness

The study also sought to determine if ICS is an effective tool of managing finances of the SMES in Eldoret Municipality. The results were as shown below. The results in the table above show that 51.1% of the respondents agreed that ICS is effective in financial management among the SMEs in Eldoret Municipality while to 41.1% did not agree. Furthermore, a small percentage (7.8%) of the respondents was of the view that ICS is moderately effective in financial management.

DISCUSSION

Internal control system is an effective tool for financial management in any business regardless of the size. The findings of the study show that SMEs in Eldoret Municipality have not been left behind in ICS implementation since more than half of the respondents agreed that they had ICS in place.

Among the ICS available are the segregation of duties, authorization of transactions, retention of records, supervision, physical safeguards or restrictions and process controls. These findings concur with those of Bogonko and Ndiwa (2014). They, however, disagree with those of Anduuru (2005) who states that SMEs have not established elaborate systems of internal controls.

The study further found that majority of SMEs in Eldoret Municipality never evaluated the ICS. Only a few respondents indicated that they often did the evaluation mainly using the audits. The findings are at par with the observations of the Institute of Internal Audit (2008) that the internal audit’s role is to evaluate the internal controls. Despite the fact that some of the SMEs have ICS, many face the challenge of lack of knowledge on how to develop and implement it. Complexity of

business operations is also a great challenge affecting SMEs in Eldoret Municipality. The findings agree with the views of Nyabwanga (2011), Atieno (2009) and Filder and Webster (1996) who all point out that SMEs are in dire need of training so as to gain knowledge on how to put up effective systems in their businesses. The study findings also showed that the ICS is effective in financial management among SMEs in Eldoret Municipality. This means that SMEs are keen on ensuring that their finances are well managed and have not ignored this practice as Wanjohi (2010) and Nguyen (2001) state. These findings rather support those of Nyakundi *et al.* (2014) who affirm that ICS influences financial performance of an SME.

Conclusion and Recommendations

SMEs play an important role in the economies of both developing and developed nations. They contribute largely to the well-being of the individual, society and the world at large. The economic pillar of the Kenya Vision 2030 development blue print expresses the government's commitment to boost SMEs as a means to becoming a middle-level income economy. It can be concluded that SME entrepreneurs in Eldoret Municipality are aware of the importance of SMEs in their operations. This is why they have put them in place. Therefore, the existence of ICS positively impacts on the financial management. Despite the challenges faced while developing and implementing ICS, SMEs still have a chance for continuous improvement. Based on the findings of the study, it is recommended that further research should be carried out on the ways to encourage the SMEs on the need to implement and evaluate the ICS. Moreover, more scholarly works need to be done on the challenges to address the challenges facing SMEs while developing and implementing the ICS.

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