

An Analysis of Practices of Internal Controls in Small and Medium Enterprises in Albania

Nertila Cika¹

Abstract: Small and medium enterprises currently represent the major part of economic activities throughout the world. In Albania, they represent the largest proportion of all types of enterprises, providing a lot of opportunities for employment. Mechanisms of internal control are a tool and a way of monitoring the human resources activities of SMEs. It plays an important role in the prevention and detection of fraud and protection of physical and intangible resources, and leading to high efficiency and smooth functioning of the business. This study examines and describes the effectiveness of internal control systems in Albanian small and medium size enterprises. The study focuses on the five main components of internal control and their impact on achieving the company's objectives. To achieve these objectives we formulate one research question: To what extent does the internal control system of SMEs comply with the principles of effective internal control? The literature review chapter is based from various resources such as books, articles and online papers. We will use questionnaire to collect data pertaining to the five essential and interrelated components of internal control: control environment, risk assessment, information and communication, monitoring and control activities. After obtaining adequate theoretical framework and practical data, a comprehensive analysis is carried out based on these data. This study has shown that SMEs in Albania has a solid and effective internal control system, but still it needs more improvement and generally it requires more attention from the board members.

Keywords: SMEs; internal control; control environment; risk management; control activities

JEL: M40; M41

Introduction

Small and medium enterprises (SMEs) are more prone to loss of employees, and less able to absorb these losses than large corporations. The main objectives of entrepreneurs are profitability and growth; business should be characterized by new strategic practices and continuing growth. (Smith, 1997) The contribution of SMEs to the Albanian economy is also very important. They provide indirect support and income growth. SMEs are also able to provide goods and services similar to large companies. The development of SMEs is a key to the country's regional development. Moreover, the growth of SMEs, have affected governments to include the sector in the formulation of strategies and programs of economic development.

For management of assets and the efficient use of it, to ensure reliable accounting information for law enforcement, management of the entity designs procedures that constitute the internal control system. Drafting of these procedures is determined by a number of factors, among others by the costs and benefits, the size of the entity and the level of organization of accounting. Accounting is built around internal controls, thus becoming an important tool for providing necessary information for the management of the property and its efficient use. Accounting professionals can and should play an important role and leadership helping the entity to follow an integrated approach and oriented unit of

¹ PhD, University of Tirana, Faculty of Economics, Albania, Corresponding author: nertila.cika@albaniaaudit.com.

risk management and internal control, which then helps in the creation, growth and preserving shareholder value.

Small business sector is well represented in Albania and is similar in structure to that of the European Union. The part of micro enterprises in total, according to INSTAT is about 96.2%, being higher than the EU average (92%) (INSTAT, 2017). The force of economic development in Albania is the private sector. This sector is growing constantly; it produces 75% of GDP and employs 83% of the workforce (INSTAT, 2017). The contribution of Albanian SMEs in the economy, as measured from the value added (75%) is higher than the EU average (58%). Following the same model, the contribution of Albanian micro enterprises in employment is 48% higher than the European average (30%). Consequently, the total contribution of the SME sector in employment Albanian is 83% greater than the EU average (67%) (INSTAT, 2017).

Internal control is a very important part of the management systems of entities and their ability to manage risk. It is a basic factor to support and realize the achievement of the objectives of the unit and for the creation, establishment and protection of the values of its owners. A developed system of internal control allows the entity to obtain and collect as many opportunities and avoid market pressures creating her the opportunity to save money and time, to encourage the creation and preservation of entity values. Strong Internal Control System gives the opportunity to the entity to take more risks, making it more competitive in the market where it operates. An effective risk management and an effective Internal Control System should be a key part of good governance at every level of an organization and throughout its operations (IFAC (IFAC), 2011)

Internal control is a tool by which are directed, monitored and measured resources of these SMEs. He plays an important role in the prevention and detection of fraud and physical protection; moreover it leads to high operational efficiency of the business. Therefore if there is a strong system of internal controls to monitor and run businesses, the prospect of bankruptcy reduces. (Sampson, 1999) Internal control means different things to different people. (COSO, 2013) Therefore, it is determined by many definitions that affect many aspects of entities in different ways and somewhat creates confusion among business owners and other stakeholders. Harrison (2011) argues and shows his opinion on the definition of internal control which is “a system of procedures implemented by management of the company”. It is designed to follow company politics, promote operational efficiency for data reliable accounting and in accordance with legal requirements. “However most widely accepted definition and used more wisely in relation to internal control, is found in a publication called the Internal Control - Integrated Structure (1994) and updated by the most recent edition of 2013. This integrated structure was established by COSO which is one of the organizations that is created to develop recommendations for public companies and their independent auditors.”

An important element of internal controls are effective financial controls, including conducting proper accounting records. This is because they help to ensure that the entity does not necessarily expose to financial risks that can be avoided, and that the financial information used within the entity and published one is reliable. These financial controls also help to ensure the protection of assets and to prevent and detect fraud. Internal and external environment where the unit operates, continuously change. The internal organization of the entity and its objectives may change consistently and the entity consequently faces risks that are constantly changing. Therefore, a strong internal control system also depends on the overall assessment, the nature and extent of risks that is exposed to. During the history of the development of internal control system has had a large number of attempts to give a definition of it. Obviously the achievement of just a comprehensive definition, as in other

fields of study, is almost impossible. Developments occurred in entities, in their management, change in social, political and economic environment influence and affect the dynamics of the definition internal control. According to Vaclovas Lakis, Giriūnas Lukas (2012) Constant changes in the size, functions and roles of internal control have made not possible to form a common definition of internal control and identify his place in the organization.

The rest of the paper is organized as follows: In the first part we will present a brief literature review about the components of internal control. In the second part we will explain the Methodology that we have used to gather and process data about the internal control components of the small and medium Enterprises in Albania. Next we present the main results we have obtained from the analysis of the primary data, gathered by questionnaires. Last we conclude by presenting the main findings of our study.

I. Components of Internal Control: A Brief Literature Review

According to COSO (2013, p. 17), internal control primarily consists of five interrelated components, which are considered as criteria for determining and achieving an effective system of internal control. These components are made in accordance with the management style and philosophy, making the differences from one entity to another, and are inseparable with the management process. COSO also suggests some tools or guidelines to help business to assess and improve their system of internal control through these five related components, which will be analyzed in more details below.

1. Control environment

As mentioned by Edward Chow (2005, p. 10), the control environment is the most important element of an entity, not only in the framework of internal control, but also in all the operations that this element is involved and that influences in the organizational structure, objectives and risk assessment. On the other side the control environment “sets the tone of an organization, influencing the control consciousness of itsemployees” (COSO, 2013, p. 23). The control environment also can determine the structure for some entities, as well as a routine ethic work of people employed.

2. Risk Assessment

The facts show that regardless of the size, structure or different industry every business entity can not avoid the impact of risk. Risks can come from inside or outside of the enterprise. The fact shows that doing business is always going along with the risk. The higher the risk, the greater is the profit that can be achieved. However, there is no component that can reduce all risks to zero. Risk assessment can be seen as the basis for determining risk management of entities. Specifically, risk assessment and identification is a precondition for determination of risk solutions. In order to take the right decisions to direct the company, managers need to know the level of risk for each activity, and so they can know which decisions can be accepted by adapting to that level of risk.

3. Control Activites

As stated in the Internal Control of the structure of COSO (2013, p. 49), control activities are policies and procedures to ensure that management directives are carried out. These policies and procedures are intended to support other activities necessary to minimize business risk and to enable assistance to proper implementation of the objectives and efficiently throughout the enterprise. Once managers

identify risks, they are also responsible for the designation, implementation and monitoring of control activities to prevent or reduce the identified risks.

4. Information and Communication

It is believed that the information and communication control environment, risks, control activities and their implementation should be reported to superiors, and move from the highest to the lower level of management, as well as horizontally in an enterprise. There is no doubt that information is needed for all levels of management to support their operations and to meet the objectives in terms of financial reporting and their compliance. All information used in business are so closely related to each other. For example, financial reporting is not only used from third parties or public, but also it plays an important role in the decision-making process or budget. Moreover, the quality of information affects the ability of managers to make decisions and control of business operations. Also shows the appropriateness of the data in the respective reports. (COSO, 2013, p. 92) Communication is one of the most natural attribute of information systems. Communication is defined as the availability of information from external or internal parties of the entity, in such ways as; from higher levels to lower ones, from the lowest levels in the higher ones, as well as between units connected horizontally. It is noted that internal control is effective when the communication process is carried out fairly, reliably and done accurately on time. (COSO, 2013, p. 93)

5. Monitoring

Monitoring is the last part of the internal control which is referred as “the process that assesses the quality of system performance as time passes. This is achieved through ongoing activities, separate evaluations or a combination of both” (COSO, 2013, p. 69). Monitoring of course plays an important role in the system of internal control; it helps in maintaining its effectiveness during different periods. Monitoring is carried out across the whole enterprise activities in two ways: continuous monitoring and special evaluation or shared.

II. The Methodology of the Study

To complete this study a research strategy should be well defined. This requires the analysis of various research strategies to assess the best method that suits better with the purpose of this research. In order to choose the most suitable method there are analyzed advantages and disadvantages of every method to justify the methods that satisfies more the goals. Other factors that have been considered to choose this research strategy are availability of the collected data, data reliability and ease of data collection. Research methods that have been analyzed are different. To decide in choosing the most appropriate research method are taken into account the objectives of research, time constraints to complete the research ,the real possibilities of gathering information and economical and political development in Albania. For this purpose it has resulted that the best research methodology is descriptive and analytical.

We have reviewed the literature in order to get a better understanding of developments in the field of building a SIC (System of Internal Control) and SC (System of Control), opinions, discussions and assessments about definitions, role and importance of SIC in decision making, about factors that impacts and should be taken in consideration during establishment of the system. From such sources such as books, foreign articles and domestic authors in the field of accounting, discussions with the regulators, associations in the field of accounting, surveys conducted by institutions or researchers,

website and other resources are collected, recorded and analyzed the data in order to identify theoretical and practical problems in this field, the debates made and the need for such a study in the specific field.

There are 2 main methods of research, quantitative and qualitative, and preference for one of these methods is related to the purpose of the paper. In our paper we have used both methods. We used qualitative methods to understand in what way the internal control system in economic entities in our country is organized. Through this method is found out which control activities are most useful, and in what form are organized the most essential aspects of internal control in the Albanian entities. Quantitative methods are used for the analysis of questionnaires like finding frequency, frequency and percentage of the presence or absence of internal control elements in the Albanian businesses. The study uses two types of data: secondary data are used primarily to create a clear idea of the concept of internal control, how it has evolved over the years. At the same time through secondary sources we identify the components of internal control and the main types of controls used by the Albanian entities. Primary data are data obtained by concrete observations made by a researcher. In the case of our study primary data were obtained from a questionnaire addressed to businesses in Albania, prepared based on the COSO framework.

The target group of our study is the set of small and medium business in Albania, while the sample selected at random consists of 86 economic entities, which operate in Tirana and perform various activities. The questionnaire was distributed to businesses in electronic form, but also in person through direct contact with representatives of economic entities. According to the type of activity, business part of our study consists of: manufacturing businesses 22.1%, service 43%, construction and trade respectively 4.7% and 22.1%. Other businesses that are not classified in any of the above groups are 7 in total, so 8.1%. It can also be a coincidence, but by this we can notice that the service sector in recent years occupies a significant part of the market.

III. Results of Analysis of Primary Data

Before presenting the analysis of the questions about the internal control activities, we will give several outlines about some general descriptive statistics regarding the sample included in this study. Most of the respondents are economists at around 38.37%, followed by managers at a relatively high percentage of approximately 20.93% and followed by IT/programmer and those with a technician position constituting respectively about 12.79% of the sample taken in study. Persons in other professions make up to 15.12% of the total. Analyzing this data we can understand that the majority of the people that answered this questionnaire are those who are in charge or directly involved in implementation of Internal Control System. This is the reason that their answer reflects the reality of what happens in the companies where they are employed.

Most of the respondents belong in the group of seniority from 1-3 years in their current job and make up 37% of the total. Followed up by those employed in the last year with 30% of the total and the other group with 3-5 years of work experience have a considerable part of 26%. An interesting factor taken to study is the gender of the target group. About 55.8% of the respondents are females and the other 44.2% are males.

The rest of the questions in the questionnaire cover the internal regulation, politics of the company, and other practices of internal control. Regarding the question about internal regulation and policy, respondents answered that they have moderate and even full knowledge about their company policies. Only a small part of the respondents answered that they have no knowledge about this topic.

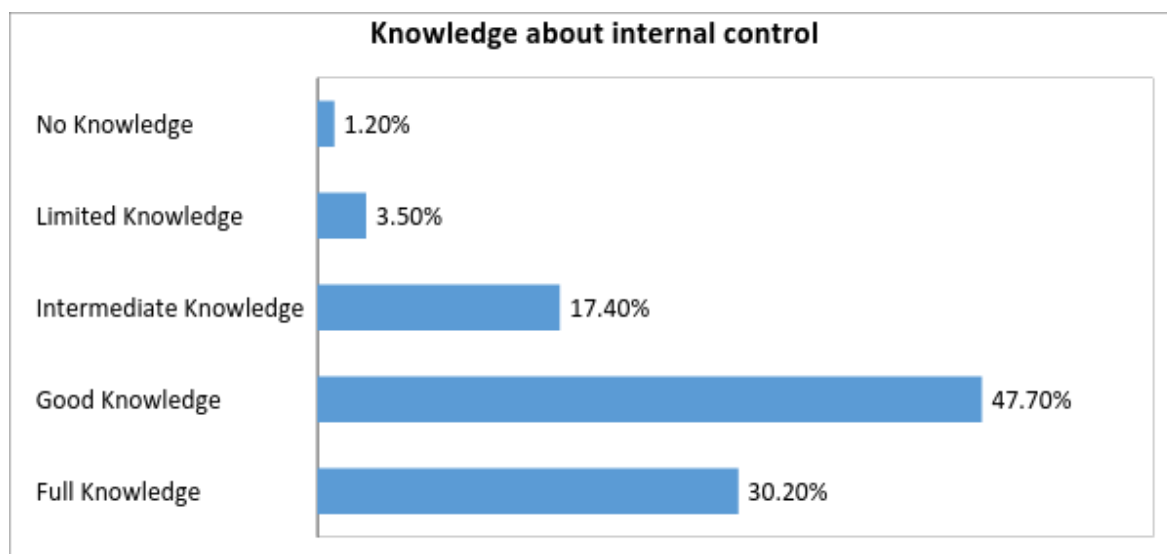


Figure 1. Knowledge about internal control

This element is very important and is a key factor in the performance of daily work of an employee. Company's internal regulation should be well known, to respect then all the rules and ethical behavior leading so to an effective operation of internal control. So at this point we can say that most of the employees are aware of this regulation.

Some practices in terms of existing control environment in the studied companies are adjusted through questions about personnel records, recruitment and training process. More specifically, the data are presented below



Figure 2. Maintaining professional certification

It is in the interest of the companies to have these elements documented and preserved, in order to be aware of the professional achievements of their employees. Preservation of these elements influences directly in achieving a more effective internal control.

- Regarding to recruitment and training, 50% of the respondents answered that they had training before beginning of work officially, but 31.3% of them do not have one and 18.8% are not aware if their company offered training for new staff.



Figure 3. Information if there have been a process of recruitment or training

Training is a key element, because during which new employees understand work processes in the company, they also learn internal regulation. Avoiding training process may lead to a case of fraud or theft being or not aware of them.

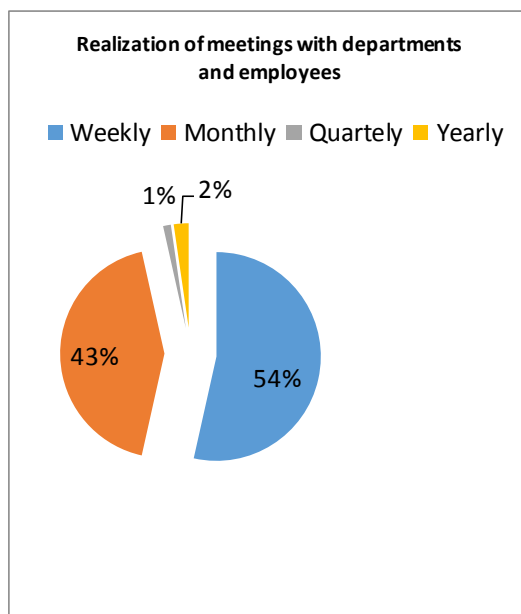


Figure 4. Frequency of meetings realizations with departments and employees

Employees are also asked about meetings that managers or administrators organize with relevant departments and the level of integrity and transparency in these meetings. Organizing frequent business meetings is good, because in this way you observe closely the implementation of tasks by employees. 55% of responders answered that managers and administrators organize meetings weekly with employees, 43% monthly and a very small percentage in 4-month periods or annually. Frequent meetings organization by employees' side can be seen as a pressure by the management company, but it is a key element on achieving company's objectives.

Regarding the issue of integrity, the most respondents answered that the elements of integrity and transparency used in these meetings are considerably of high level. To achieve the higher goals and an effective internal control is suggested that leaders should show high level of integrity and transparency, which is reflected in the answers given by asked employees.

One of the most important elements of the Internal Control System is the segregation of duties. From the analysis of responses on segregation of duties, in order that no one shall not have full control or authority over a particular transaction resulting data as follows:

Table 1. Segregation of duties and responsibilities of employees in company

Level of clarity	Frequency	Percentage
Very clear	22	25.5%
Clear	38	44.2%
Lightly clear	21	24.4%
Unclear	5	5.9%
Do not now at all	0	0%
Total	86	100%

Source: Primary data

There are 26 businesses that do not have a clear segregation of duties. Generally, this lack of segregation of duties is present mainly in small businesses, where the number of employees is small and so the same person for example, can record transactions as well as he can make payments and receipts. This procedure is quite negative because it creates space for certain individuals to have the opportunity to abuse with the power that is given causing damage to business without being detected. One of the important components of internal control is the identification and risk assessment. To understand how the Albanian entities take precautions to identify risk before they suffer damage and caused trouble, there are the following responses regarding to this.

Specific objectives. In this part, we have formulated the question in order to get the employees awareness of the company's operating objectives. As a result, 91.7% of responders stated that they are aware about this issue and 8.3% of them do not know or do not care about this. Although small percentage, the fact that there are employees in the company that do not know the objectives that the company wants to achieve, is not a strongly desirable element. Each employee at the moment that is part of a working group should definitely be informed about the objectives required to be achieved.

Updated information. About the question of how often the company does update information for the market economy conditions, competitors or changes in laws, we have introduced in parallel financial reporting compliance with basic principles such as the completeness, accuracy and validity. Normally update of information should be made in accordance with these principles, so we have analyzed in parallel with each other these two elements.

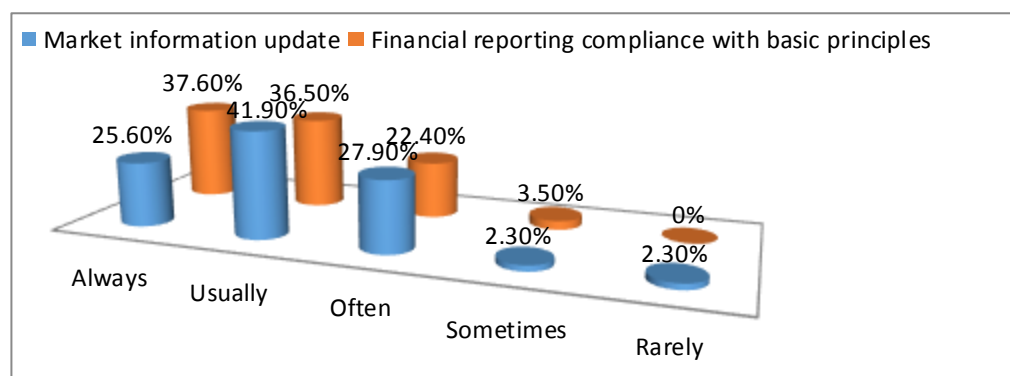


Figure 5. Market information update and financial reporting compliance with basic principles

Maintenance of assets and information. A vital activity control, which should be part of the internal control system of any entity, is to protect its physical assets. Three areas of application for this are (1) inventory controls, (2) controls of the documents, and (3) cash controls.

Regarding the companies included in this study it appears that a good portion of them are protected at this point. For a moderate security are answered 23.3% of the responders. At a satisfactory level of security are answered about 58.1% and a tiny part, about 1.2% reported a lower level of security of the company at this point. Generally we see the responses given by the companies in the study have an acceptable level of protection to assets and information, which affects the effective implementation of internal control.

Information and communication. The information must be recorded and communicated to the appropriate level of management and others within the entity, in an appropriate form and within a time frame that makes possible the realization of responsibilities and other controls. When an error or a fraud occurs, most employees tend to notify immediately for this problem their managers. 90.7% of responders said "Yes" to this element and only 8.1% said "No".

To minimize the risk of fraud, managers or executives devise motivation policies to encourage employees to report any reasonable suspicion to the managers of the company. Below is the connection between the two elements.

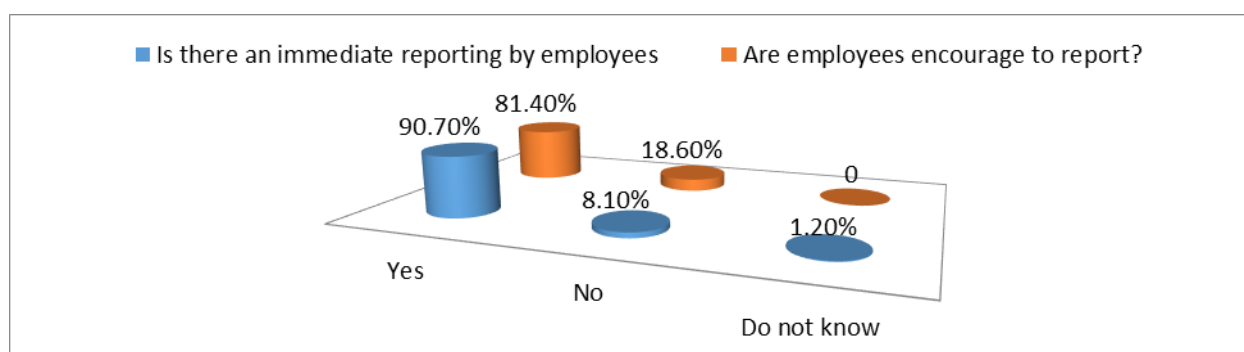


Figure 6. Reporting a problem from employees

We can notice that these two elements are connected in parallel with each other. So the immediate reporting of problems is related to the encouragement given by the direction in order that this report occurs. Customer complaints are always bad news for all companies because their purpose is customer satisfaction. Therefore, whenever there is a complaint from consumers, employees and managers rush to check and find out the reason for this error. 91% of respondents said that the company always tries to find the causes of customer complaints and to reimburse them if this is necessary and only 2% stated that these complaints are not taken more into consideration.

Previous cases of fraud. Another aspect that can be analyzed to assess the functioning of the internal control of the companies in the study is the occurrence of fraud and theft in earlier periods. From the study and the answers given, it turns out that only about 1/3 of the employees questioned answer with certainty that there were no cases of fraud in the past. 29.1% of the responders, which translates into 25 businesses claim fraud, occurred, while the remaining 37% were unaware of this part. But this should not be taken as an element of not occurrence of theft or fraud, as this element could have happened, and the management of the company does not want new employees to be aware of this fact.

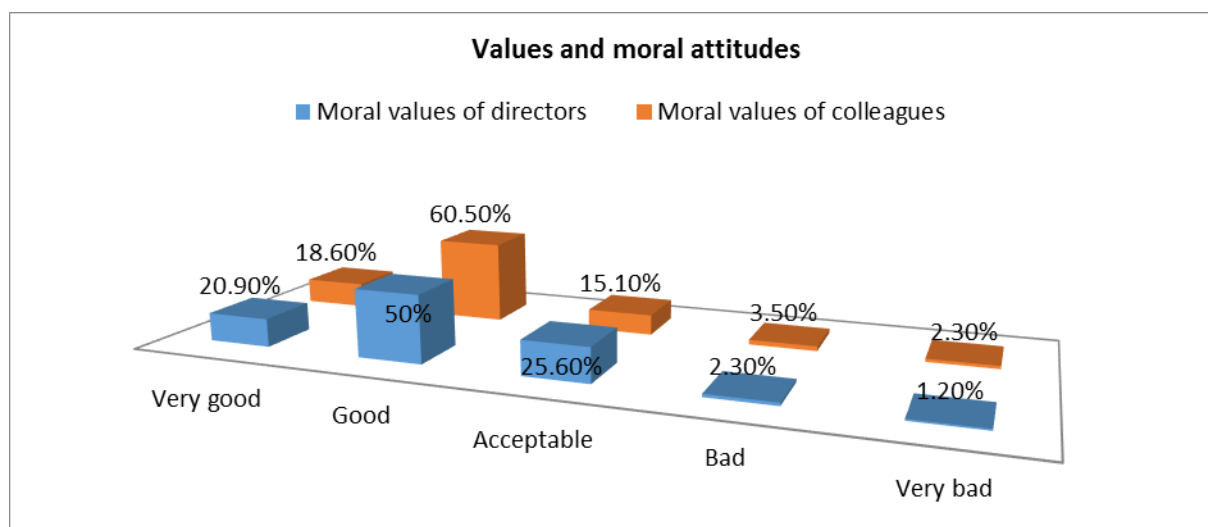


Figure 7. Values and moral attitudes

Failure of implementation of moral attitudes, as by the directors, as by employees, will led to unwanted cases of fraud or theft and so in a failure of effective internal control.

IV. Main Findings and Conclusions

This paper is focused in the internal control system for small and medium enterprises. We try to investigate which of the control activities prevail more than others. We find out that the medium enterprises have a somewhat completed control system, yet there are several problems that may be noticed.

A sound system of internal control cannot be built without the management of the owners of the entities. In addition, management philosophy can be detected through the level of integrity and transparency that managers show in their work. Over 72.1% of responders feel a level of middle and high ethical standards by management and their board of directors. From Table 4.3, the interaction between the board of directors with senior staff are simply enough with most of the meetings conducted weekly and monthly. This means that companies basically have a good foundation for designing a sound system of internal control. However, the number of companies that prove otherwise should be taken into consideration and should be seen further improvement opportunities.

The segregation of duties is a essential element of control in order to avoid duplication of work and assignment of responsibilities, but this aspect is missing in most of the businesses in the study. Into small business, but not only, we have the case of a single person who does some works at the same time, which normally should not be done.

This paper highlights the weaknesses of the information and communication components in the Albanian entities. Documentation of procedures for carrying out certain actions or documentation of knowledge and skills for a working position is missing not only in small business, but also in medium-sized businesses. Albanian businesses generally do not consider very important the presence of written procedures, verbal communication of many issues is still very present in our entities.

Regarding the physical asset and data protection, this element becomes necessary to sign, because some employees, who actually represent the respective companies, feel that their system of control at this point has begun to fade somewhat. Thus, companies need more solutions to protect assets and data in a secure way.

Companies have suffered from fraud in earlier periods, as almost 1/3 of the responders confirm this fact, and at this scale is also the percentage of those who are not informed about this part.

However, about the moral values and attitudes of the current directors, the majority of responders have a good impression for this part. Similarly, some current ethical standards of colleagues, respondents believe that they are working with ethical people. There are few entities where these moral values do not apply. Failure of implementing the moral attitudes, as by the directors, as by employees, will necessarily lead to unwanted cases of fraud or theft and in a failure effective internal control. In short, we can say that the companies have experienced fraud or theft in the past, but in this working environment, are mostly assessed ethical values of directors and employees.

Finally, we conclude that the Albanian economic entities somehow recognize the importance of internal controls. They have made progress towards the construction and operation of a structured control system, but have a long way to make up its consolidation. It remains a big challenge especially for small businesses, which should understand that the investment performed in this context could burden their finances at present, but will give the fruit in close future, will serve in building a secure and profitable future.

Bibliography

Smith, Adam (1997). *Corporate Fraud and Internal Control Workbook: A Framework for Prevention*.

Chow, Edward (2005). *Internal Control and Risk Management - A Basic Framework*. Internal Control over Financial Reporting: Guidance for Smaller Public Companies - Publisher: American Institute of Certified Public Accountants, 2006, AICPA Committee of Sponsoring Organizations of the Treadway Committee (COSO). (1992). *Internal Control Integrated Framework, Executive Summary*. www.coso.org.

Committee of Sponsoring Organizations of the Treadway Committee (COSO). -Internal Control – Integrated Framework – December 2011, New issue *Internal Control – Integrated Framework (Framework)*, May 2013

Harrison, H. & S. (2011). *Financial Accounting. International Financial Reporting Standards, 8th edition*. Institute of Statistics (INSTAT), (2017) – *Reports about SMEs in Albania*.

Sampson D. (1999). *Understanding Internal Controls: A Reference Guide for Managing University Business Practices*. University of California.