

Internal Controls and Financial Performance of Small and Medium Enterprises in Mbale City, Uganda

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Abstract

The objective of the research was to examine the impact of small and medium enterprises' internal controls on their financial performance in Mbale city, Uganda. In this study, internal control was proxied using two of the five components of internal control as set out by the Committee of Sponsoring Organizations, control environment and control activities, while financial performance was measured using profitability. Descriptive research design was endorsed due to its potential to describe the connection between components of internal controls and SMEs financial performance. The study randomly sampled 87 SMEs in Mbale city. Primary data was gathered using structured questionnaire. Inferential statistics involving nonparametric correlations and ordinal regression were used to analyze the data. The study findings revealed that internal controls have no significant association with the financial performance of SMEs.

Keywords: internal control, control environment, control activities, financial performance, small and medium enterprises

JEL classification: M00, M19, M49

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1. Introduction and literature review

Small and medium enterprises (SMEs) play a crucial role in the economic development of many countries, including Uganda. These businesses contribute significantly to employment, poverty alleviation, and innovation. In Uganda, SMEs represent over 90% of the private sector and employ a large portion of the population. Specifically, in cities like Mbale, SMEs are vital to the local economy, as they provide goods, services, and employment opportunities, particularly in urban areas with growing populations. However, despite their significance, SMEs face a number of challenges like limited access to finance, insufficient infrastructure, and lack of strong internal controls. Many SMEs have internal controls that are weak, leading to imperfect financial performance, inefficiency, and even collapse of businesses. This is particularly true in cities like Mbale, Uganda, where SMEs often struggle with resource limitations and ineffective financial oversight.

Internal controls allude to the mechanisms, procedures and policies set up by businesses to ensure reliability and accuracy in the safeguard of assets, fraud prevention, and financial reporting. Internal controls are created to promote transparency, accountability, and operational efficiency, all of which are essential for business sustainability in the long-term. Internal control systems are designed to ensure that financial and operational risks are managed effectively, and that business objectives are achieved while maintaining compliance with

regulations. Proper internal controls are essential for SMEs to safeguard their assets, ensure the accuracy of financial reporting, prevent fraud, and make sound decisions. However, many SMEs in Uganda, particularly in Mbale city, operate without robust internal controls, which negatively impacts their financial performance.

Despite the recognized importance of internal controls, there is limited research on their role in improving the financial performance of SMEs in Uganda, particularly in Mbale city. Existing studies have primarily focused on larger enterprises or the broader national context, leaving a gap in understanding the specific needs and challenges of SMEs in smaller cities. This research aims to bridge this gap by exploring how effective internal control systems can enhance the financial performance of SMEs in Mbale city. In an attempt to give conceptual clarification for the variables of the study, it reviews two of the five components of internal control as provided for by the Committee of Sponsoring Organisations' framework, including the organization's control environment and the organization's control activities (COSO, 2013). Therefore, this study seeks to investigate how control environment and control activities associate with financial performance of SMEs in Mbale city, Uganda. By focusing on the unique challenges and opportunities faced by SMEs in this region, the research hopes to provide valuable insights that can guide local businesses in improving their internal control practices and, in turn, their financial outcomes.

According to Uwadiae (2013), control environment means a set of processes, standards and structures that dispense the basis for setting out internal control in all parts of the organization. Control environment consists of the operating style and philosophy of management, ethical values and integrity, issuance of responsibility (accountability) and authority, human resource practices, including performance appraisal, training, compensation, employee counselling, and remuneration (Inusah & Abdulai, 2015), while control activities include actions considered to deal with risks to the achievement of objectives by an entity and the procedures and policies put in place by an entity to help make certain that directives of management are fulfilled (COSO, 2011). It includes approvals, authorizations, verifications, segregation of duties, security of assets, reconciliations, and review of the operating performance.

The study's theoretical contributions aim to expand existing knowledge on the role of internal controls in SME financial performance, particularly in a developing country context like Uganda. By examining SMEs in Mbale city, the research will contribute to understanding the importance of internal controls in a setting where resources are often limited, and businesses face unique challenges. This will enhance the theoretical frameworks of internal control systems and their application in SMEs, particularly in Sub-Saharan Africa. From a practical standpoint, the research findings will provide valuable insights for SME owners, managers, policymakers, and financial institutions. The study will offer recommendations that are practical in ameliorating systems of internal control in SMEs, which could lead to better financial management practices, reduced fraud, and overall improved business performance. Furthermore, the study could guide policymakers in designing support mechanisms to enhance the capacity of SMEs in Uganda, promoting sustainable economic growth.

The significance of this study lies in its ability to improve the sustainability and profitability of SMEs in Mbale city and Uganda at large. By shedding light on the link between internal control and financial performance, the study can encourage SME owners to adopt better financial practices and improve decision-making. Furthermore, the research could serve as a valuable resource for other scholars, financial institutions, and governmental bodies seeking to improve the overall business environment for SMEs in Uganda.

This study seeks to address the lack of sufficient mechanisms of internal control in SMEs and their effect on the financial performance of these businesses. Many SMEs in Mbale city suffer from poor financial management, resulting in financial losses, mismanagement of resources, and even business closures. These issues are compounded by a lack of financial literacy, inadequate managerial skills, and limited understanding of the significance of internal control frameworks. Therefore, the study investigates the relationship between internal control systems and the financial performance of SMEs in Mbale city, Uganda.

1.1. Theoretical review

■ *Institutional theory*

Institutional theory was propounded first by [Meyer and Rowan \(1977\)](#), then reviewed later by [DiMaggio and Powell \(1983\)](#). The theory submits that organizations design and develop systems, practices, procedures, and structures not essentially on coherent economic cost-benefit review, but rather because they are needed to embrace new systems, practices, procedures, and structures. As put by [Meyer and Rowan \(1977\)](#), “institutions are steered to embody the procedures and practices described by prevalent justified notions of institutional works and then organized into society. Institutions that succeed to do so raise their survival and legitimacy odds, self-sufficient of the instant effectiveness of the procedures and practices acquired”. The authors additionally state that structures in organizations like systems of internal control are signs of social accountability and conformity. [Arwinge \(2013\)](#) also asserts that in an organization, controls are designed and adapted so as to raise legitimacy and survival possibility. The legitimacy theory is therefore in concert with Sarbanes-Oxley compliance requirements and corporate governance, aimed at instilling transparency and credibility in financial reporting and operations of business.

■ *Agency theory*

This theory was advanced by [Ross \(1973\)](#). The theory describes how best relationships are organized in such a manner that work is determined by one party, while work is done by another party. [Jensen and Meckling \(1976\)](#) state that in the principle-agent relationship, principle charters an agent to undertake a task that the principle cannot do. The authors additionally assert that the agency theory explains systems of internal control to be necessary structures through which control is exercised, hence minimizing dishonest behaviour by agents. Because both the principle and agent are interested in maximizing utility, the agent may arrogate managerial etiquette that is not in the principles interest. [Shankman \(1999\)](#) explains that efficient mechanisms of governance between the principle and the agent would lead to a minimized conflict of interests by them. [Sharma \(1997\)](#) did note that agency theory is rooted on the premise of separate of ownership and control where managers are independent and are plausible to increase their rewards at the owners’ expense. In the agency theory, self-interest of the agents was condemned by [Bruce et al. \(2005\)](#) to be extremism premise. The authors argue that it makes goal consonance not realistic, since the theory puts more focus on the principal-agent association, which gives the principal the right to define work, while the agent is to execute the work.

1.2. Empirical review

[Kisanyanya \(2018\)](#) examined the impact of the systems of internal control on the financial performance of higher learning institutions owned by government in the County of Vihiga, Kenya. The study specifically examined how information and communication, risk assessment, monitoring, control activities, and control environment affect financial performance of higher learning institutions in the County of Vihiga, Kenya. The study used survey research design to obtain information from the participants that were sampled. Analysis of data was made using descriptive statistics and multiple regression. The findings revealed that higher learning institutions had effective and sufficient control activities that consisted of segregation of duties, physical controls on assets, authorizations and review of operating performance.

[Umar and Dikko \(2018\)](#) did a study in Nigeria to investigate the impact of the systems of internal control on the performance of commercial banks. The study used a survey technique to create a method for drawing out information from sampled respondents. The study results indicated a significant and positive association between control environment, monitoring of risks and control activities, and performance of the bank. This result conforms to the ones of [Hermanson et al. \(2012\)](#), who noted that the strength of components of internal control is related positively to the public company status and the chief audit executives reporting to the audit committee.

Muraleetharan (2011) carried out a study on the association between systems of internal controls and financial performance amongst public and private entities in the district of Jaffna, Sri Lanka. The study was conducted on 150 workers in the entity. The study results revealed that control activities are statistically significant in ascertaining financial performance of private and public entities. Sufficient supervision with limpid and recently supplied information should be present. Sustainment of sufficient recording systems must be there and also there should be an efficient system to control staff, including laid down directions as to the duties and responsibilities of staff and management.

Nyakundi *et al.* (2014) investigated the effect of systems of internal control on financial performance among SMEs in the city of Kisumu, Kenya. The study employed both secondary and primary data. The study gathered primary data by use of structured questionnaires and interviews, while financial statements of enterprises that were sampled provided secondary data. Analysis of data was made using inferential and descriptive statistics. The study findings revealed that a notable switch in financial performance was connected to systems of internal control. Based on the study findings, the study did conclude that systems of internal controls significantly affect SMEs financial performance.

Magu and Kibati (2016) established the impact of systems of internal control on the financial performance of the Farmers' Association of Kenya Ltd (KFA). The study targeted a population of 78 managers. The research was explanatory in nature, while data was analyzed using descriptive and inferential statistics. Study results indicated that staff had not been trained to administer the financial management and accounting systems, and that the security systems did not recognize and protect assets of the organization. The findings also revealed that control activities and control environment were responsible for up to 61.3 percent of the dissimilarities in financial performance.

Alawattagama (2018) made a study whose findings indicated an insignificant association between control activities as a measure of systems of internal controls and financial performance. These findings corroborate with the results of Ejoh and Ejom (2014), who examined the connection between systems of internal control and financial performance of tertiary institutions in Nigeria. Data was gathered using interview guide and questionnaires, as well as article and document review. A survey research method was used to analyse data, while respondents were selected using stratified sampling techniques. The study findings indicated that there was no significant association between systems of internal control and financial performance.

1.3. Statement of the problem

For a long time, there has been a diminishing pattern in the performance and growth rate of SMEs in the region, and this is attributed to several factors (Eton *et al.*, 2021). The authors indicate that SMEs often cite some obstructions to their smooth operation and performance which may steer some SMEs to collapse or achieve below optimum performance levels. Olowe *et al.* (2013) submit that the performance of several SMEs is substantially affected by insufficient financial and other controls and systems and, as a consequence, they collapse before making it to their life cycle growth stage. Fatoki and Smit (2011) assert that notwithstanding the part played by SMEs in economy, and the succour offered to SMEs, a number of SMEs die off within three years following their set up. Odek and Okoth (2019) reveal that systems of internal control are tools of management and that entities establish internal controls to enhance and check on effectiveness and efficiency of their operations, thereby improving on their performance financially.

Earlier studies done on financial performance and systems internal control have ingrained a coaction association between systems of internal control and financial performance (Shanmugam *et al.*, 2012; Xiao, 2011; Putra, 2013; Atristain Suárez, 2016). In spite of that, most of these studies were conducted in the developed world, except for a few (Monday *et al.*, 2014; Nyakundi *et al.*, 2014) that were made in the developing world, leading to a contextual gap. Studies made on systems of internal control and financial performance provide different findings, whereby some claim a significant relationship exists (Rosman *et al.*, 2016), while some reveal

that there is no significant relationship (Ejoh and Ejom, 2014). In general, no conclusive findings are provided by studies carried out so far, in that they are deficient of a coalesced position of how systems of internal control explain financial performance, thereby creating an empirical gap.

The high rate of failure amongst SMEs in Uganda amid established systems of internal control and the unpredictability resulting from empirical and contextual gaps does present a reasonable justification to conduct an inquiry on the association between systems of internal control and financial performance amongst SMEs in Mbale city, Uganda.

1.4. Research objectives and study hypotheses

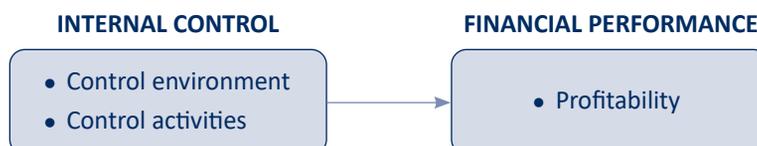
The research objectives are as follows:

- ✓ To assess the association between control environment and financial performance of SMEs in Mbale city, Uganda.
- ✓ To determine the connection between control activities and financial performance of SMEs in Mbale city, Uganda.

The study hypotheses are:

- ✓ H01: Control environment does not have a significant association with financial performance of SMEs in Mbale city, Uganda.
- ✓ H02: Control activities do not have a significant connection with financial performance of SMEs in Mbale city, Uganda.

1.5. Conceptual framework



2. Research methodology

The study espoused a descriptive research design, since it grants the fabrication of a problem for more accurate investigation. Descriptive design was also regarded more suitable, as it permits ascertainment and description of the features of the constituents of systems of internal control toward financial performance. The study was carried out in Mbale city, Uganda. The study sampled 87 SMEs using the simple random technique. The research gathered primary data using self-administered questionnaires with both closed and open-ended questions. As indicated by Cooper and Schindler (2013), self-administered questionnaire provides the only mechanism to extract self-reports regarding the opinion of people, values, beliefs, and attitudes. Data analysis was made using inferential statistics involving ordinal regression analysis and nonparametric correlation analyses to ascertain the association between internal control systems and financial performance.

3. Findings

Table 1. Goodness-of-fit

	Chi-square	Df	Sig.
Pearson	712.692	670	0.123
Deviance	296.652	670	1.000

Link function: Logit.

Source: Study data, 2025.

The Pearson and deviance chi-square test was used to determine the goodness of fit of the model for the data. The insignificant test results ($p = 0.123$ for Pearson and 1.000 for deviance) are indicators that the model fits the data well.

Table 2. Parameter estimates

		Estimate	Standard error	Wald	Df	Sig.	95% confidence interval	
							Lower bound	Upper bound
Threshold	[PR = 2.33]	-1.493	2.535	0.347	1	0.556	-6.462	3.476
	[PR = 2.67]	-1.193	2.519	0.224	1	0.636	-6.130	3.745
	[PR = 2.83]	-0.092	2.491	0.001	1	0.970	-4.974	4.790
	[PR = 3.00]	0.820	2.487	0.109	1	0.742	-4.054	5.694
	[PR = 3.17]	0.935	2.487	0.141	1	0.707	-3.940	5.809
	[PR = 3.33]	1.350	2.489	0.294	1	0.588	-3.528	6.228
	[PR = 3.50]	1.541	2.490	0.383	1	0.536	-3.340	6.422
	[PR = 3.60]	1.588	2.490	0.406	1	0.524	-3.294	6.469
	[PR = 3.67]	1.913	2.493	0.588	1	0.443	-2.974	6.799
	[PR = 3.83]	2.148	2.495	0.741	1	0.389	-2.743	7.038
	[PR = 4.00]	3.593	2.514	2.043	1	0.153	-1.334	8.520
	[PR = 4.17]	4.291	2.529	2.880	1	0.090	-0.665	9.248
	[PR = 4.33]	5.189	2.568	4.084	1	0.043	0.157	10.221
[PR = 4.50]	6.311	2.695	5.486	1	0.019	1.030	11.593	
Location	CE	0.197	0.475	0.172	1	0.678	-0.734	1.128
	CA	0.229	0.567	0.164	1	0.686	-0.882	1.340

Link function: Logit.

Source: Study data, 2025.

✓ **H01: Control environment does not have a significant association with financial performance of SMEs in Mbale city, Uganda.**

The findings in Table 2 reveal that control environment ($p = 0.678$) has a statistically insignificant association with financial performance. The findings indicate that control environment was an insignificant positive indicator of financial performance. On the basis of the estimates, the findings also indicate that, for every unit increase in control environment, there is a predicted increase of 0.197 in the log odds of being at a higher level on financial performance.

These findings lead to a conclusion that control environment has a positive insignificant relationship with SMEs financial performance proxied as profitability. Consequently, the study fails to reject the null hypothesis that “control environment has insignificant association with financial performance of SMEs in Mbale city, Uganda”. These results corroborate with [Ibrahim et al. \(2017\)](#), who found out in their study that the impact of control environment in achieving higher financial performance remains insignificant. The findings additionally corroborate with [Chowdhury \(2021\)](#), who revealed that control environment has insignificant impact on financial performance of commercial banks.

However, the findings of this study are not in agreement with some empirical findings, including [Muraleetharan \(2011\)](#), who found out in his study on internal control and its impact on the financial performance of public and private organizations that internal controls measured as control environment, control activities, and risk assessment have a significant relationship with financial performance. The findings as well disagree with [Hanoon et al. \(2020\)](#), who disclosed in their study on the correlation between internal control components and the financial performance of Iraqi banks that internal controls have a positive significant relationship with financial performance.

✓ **H02: Control activities do not have a significant connection with financial performance of SMEs in Mbale city, Uganda.**

The results in Table 2 reveal that activities control ($p = 0.686$) is statistically insignificant. The results indicate that control activities was a positive insignificant predictor of financial performance. On the basis of the estimates, the results as well reveal that, for every one unit increase in control activities, there is a predicted increase of 0.229 in the log odds of being in a higher level on financial performance.

These results lead to a conclusion that control activities have a positive insignificant relationship with SMEs financial performance proxied as profitability. Consequently, the study fails to reject the null hypothesis that “control activities have insignificant connection with financial performance of SMEs in Mbale city, Uganda”. These results are consistent with [Ejoh and Ejom \(2014\)](#), who disclosed in their study on the impact of internal control activities on financial performance of tertiary institutions in Nigeria that there is no significant relationship between internal control activities and financial performance.

However, the study results disagree with the results of [Magara \(2013\)](#), whose study revealed that control environment, risk assessment, and control activities contribute positively and significantly to the financial performance of SACCOs in Kenya. The results of this study are also inconsistent with [Collins \(2014\)](#), who disclosed in his study on the effect of internal control on financial performance of micro-finance institutions in Kisumu central constituency that there is a positive significant relationship between internal controls, measured as control activities and control environment, and financial performance.

Table 3. Correlations

			PR	CE	CA
Spearman's Rho	PR	Correlation coefficient	1.000	0.084	0.024
		Sig. (2-tailed)	.	0.440	0.826
		N	87	87	87
	CE	Correlation coefficient	0.084	1.000	0.424**
		Sig. (2-tailed)	0.440	.	0.000
		N	87	87	87
	CA	Correlation coefficient	0.024	0.424**	1.000
		Sig. (2-tailed)	0.826	0.000	.
		N	87	87	87

** Correlation is significant at the 0.01 level (2-tailed).

Source: Study data, 2025.

The findings in Table 3 show that there was a weak positive correlation between the independent variables, proxied as control activities and control environment, and the dependent variable, measured as financial performance. Specifically, the correlation coefficient of 0.084 and a p-value of 0.440 shows a statistically insignificant weak positive correlation between control environment and financial performance, while the correlation coefficient of 0.024 and a p-value of 0.826 shows a statistically insignificant weak positive correlation between control activities and financial performance. These findings are in accordance with [Hanoon et al. \(2021\)](#) and [Al Rahhaleh et al. \(2023\)](#), whose results revealed a positive association between internal control components and financial performance.

4. Conclusions

This study investigated the association between internal controls and the financial performance of SMEs in Mbale city, Uganda. Specifically, it examined the influence of the control environment and control activities on the profitability of SMEs. The findings suggest that neither control environment, nor control activities have a significant association with the financial performance of SMEs, as measured by profitability.

These results challenge the assumption that strong internal controls directly enhance profitability in SMEs. While internal controls are generally viewed as essential for improving organizational efficiency and reducing risks, the study indicates that their impact on profitability in this context may be more complex or affected by other factors not explored by this study. The findings may also suggest that SMEs in Mbale city, Uganda, face unique operational challenges that reduce the direct benefits of internal controls on profitability.

This study challenges the widely accepted notion that stronger internal control activities and a well-established control environment leads to better financial performance in SMEs. In contrast to conventional wisdom, the findings suggest that other factors may play a more significant role in shaping financial outcomes in SMEs in Mbale city, Uganda. This study provides a unique contribution by exploring the relationship between internal controls and financial performance within SMEs in Mbale city, an area previously underexplored in literature, thus presenting new intuitions into the specific challenges confronted by SMEs in a developing country.

This study contributes to the existing body of erudition on systems of internal control and financial performance in SMEs, particularly in the context of developing economies, like Uganda. It highlights that the association between internal control and profitability is not always straightforward and may vary based on the local business environment, SME characteristics, and other external factors. The findings provide a basis for further research into understanding how internal controls can be effectively tailored to different SME settings. Future research could also be done on comparing different types of internal control mechanisms (e.g., informal vs. formal controls) and their respective impacts on financial performance. This could be particularly useful in SMEs where informal or less structured internal controls are common.

For SME owners and managers in Mbale city and similar regions, the results underscore the need to take a holistic approach to improving profitability. While internal controls are crucial for managing risks and ensuring operational efficiency, managers should also consider other strategies, such as market expansion, innovation or cost management, that could have a more direct impact on profitability. Additionally, the study does suggest that SMEs might need to adapt their internal control systems to fit the specific challenges of their operational environments, as rigid or overly complex control systems might not lead to improved financial outcomes. Overall, this study calls for a more nuanced understanding of the role of internal controls in SMEs and encourages further exploration into alternative constituents that may affect their financial performance more strongly.

The measurement tools used to assess internal control activities and financial performance may not have captured the full complexity of these variables. For example, SMEs may adopt informal or less structured internal controls, which are difficult to measure accurately using standardized tools. This study might have had a limited sample size or might have focused only on SMEs in Mbale city, which may not represent the broader SME population in Uganda or other developing countries. The results may not be treated generally to SMEs in other areas or industries.

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