



Received: 18-06-2025
Accepted: 28-07-2025

International Journal of Advanced Multidisciplinary Research and Studies

ISSN: 2583-049X

Overview of Internal Control Theory and Factors Affecting its Effectiveness in Small and Medium-Sized

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DOI: <https://doi.org/10.62225/2583049X.2025.5.4.4747>

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Abstract

This article provides a theoretical overview of Internal Control (IC) and analyzes factors affecting its effectiveness, especially within the context of Small and Medium-sized Enterprises (SMEs). IC plays a foundational role in governance, helping businesses achieve objectives, safeguard assets, ensure information reliability, and comply with legal regulations. However, IC in SMEs often faces limitations due to resource constraints, simple organizational structures, and insufficient awareness. The study

systematizes IC theory based on the COSO framework and clarifies factors from the control environment, risk assessment, control activities, information and communication, monitoring, along with specific characteristics of SMEs. The article emphasizes the necessity of understanding these factors to enhance IC effectiveness, providing a premise for empirical research and practical solution proposals.

Keywords: Internal Control, Effectiveness, Small and Medium-Sized Enterprises (SMEs), COSO

1. Introduction

1.1 Rationale and Necessity of the Study

In the context of deep international economic integration, Small and Medium-sized Enterprises (SMEs) in Vietnam, particularly in Hanoi, face both significant opportunities and considerable challenges. To ensure sustainable existence and growth, effective governance, resource optimization, and risk prevention are crucial. Among these, Internal Control (IC) plays an exceptionally vital role, acting as the backbone of the governance system, helping businesses achieve their stated objectives, safeguard assets, ensure the reliability of financial information, and comply with legal regulations.

However, in reality, IC systems in many SMEs in Vietnam, especially in Hanoi, remain limited and have not received adequate attention. SMEs often have limited resources (financial and human), simple organizational structures, and sometimes the awareness of business owners regarding the importance of IC is insufficient. This leads to several concerning issues: high operational and financial risks (leading to waste, asset loss, fraud, and errors in recording and processing transactions); unreliable financial information (affecting management decisions and stakeholders like banks, investors); difficulties in legal compliance (resulting in legal penalties and reputational damage); and limited competitiveness (hindering operational optimization, productivity enhancement, and competitive advantage maintenance).

Despite numerous studies on IC globally and in Vietnam, in-depth research specifically focusing on factors directly affecting IC effectiveness within the unique context of SMEs in a specific locality like Hanoi remains relatively limited. Hanoi, a major economic hub with a significant number of SMEs, possesses distinct characteristics regarding business culture and the legal environment. The lack of a comprehensive overview and in-depth analysis of these influencing factors complicates efforts for both businesses to improve IC and for policymakers to provide appropriate support.

Therefore, this study is essential and holds significant importance. It not only contributes to systematizing the theoretical foundation of IC and its influencing factors but also provides deep insights into the current situation and specific challenges faced by SMEs. This, in turn, creates a premise for proposing practical solutions, contributing to enhancing operational efficiency, increasing transparency, and fostering sustainable development for the SME community.

1.2 Research Objectives

This study aims to achieve the following specific objectives: Systematize and clarify the theoretical basis of internal control: Provide an overview of IC concepts, principles, roles, and objectives, with a particular focus on the COSO Integrated Framework.

Identify and analyze theoretical factors affecting the effectiveness of internal control: pinpoint and deeply analyze factors that potentially impact the ability of the IC system to achieve its objectives.

Elucidate influencing factors in the specific context of Small and Medium-sized Enterprises (SMEs): Analyze the unique characteristics of SMEs and how they influence the effectiveness of IC.

1.3 Scope and Delimitations of the Study

The subject of the study is internal control (IC), the theoretical factors affecting its effectiveness, and the relationship between these factors within the operational environment of SMEs.

The scope of the study is limited to a theoretical overview and analysis. Specifically, this article focuses on systematizing theoretical frameworks of IC (primarily the COSO Integrated Framework) and the influencing factors mentioned in scientific works. This article does not involve empirical surveys or primary data collection from specific SMEs in Hanoi, but rather serves as a solid theoretical foundation for subsequent empirical research.

1.4 Research Methodology

This study primarily employs the methods of synthesis, analysis, and theoretical systematization. The specific methods applied include:

- Synthesis and analysis of literature: Collecting and synthesizing scientific literature from various sources, including domestic and international research on IC and SMEs, specialized books, textbooks, standards (e.g., COSO), and relevant Vietnamese legal documents.
- Interpretation and induction: Interpreting IC concepts and theoretical models, and using induction to derive key factors affecting IC effectiveness in the SME context.
- Comparison and contrast: Comparing and contrasting different viewpoints and theories from various authors and organizations to clarify commonalities and differences, thereby providing a comprehensive and objective perspective.

2. Overview of Internal Control Theory

2.1 Concept of Internal Control

Internal Control (IC) is one of the most crucial pillars of a governance system. According to the widely accepted definition by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its COSO 2013 framework: "Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."

From this definition, IC possesses core characteristics: it is a process (continuous); human-driven (influenced by all personnel); provides reasonable assurance (mitigates risks rather than eliminating them entirely); and is oriented towards objectives (operations, reporting, compliance). In

Vietnam, Vietnamese Auditing Standard No. 315 (VSA 315) also provides a definition highly consistent with the COSO framework. In summary, IC is a comprehensive, dynamic, and continuous system, designed and operated by all personnel to safeguard assets, ensure reliable information, optimize operations, and ensure compliance, thereby helping businesses achieve sustainable development.

2.2 Objectives of Internal Control

IC is established to achieve specific business objectives, typically categorized into three main groups according to the COSO model:

Operations Objectives: Focus on the effectiveness and efficiency of resource utilization, including optimal asset management, prevention and detection of fraud and errors, optimization of business processes, and achievement of strategic goals.

Reporting Objectives: Ensure the reliability, timeliness, transparency, and relevance of financial and non-financial information and reports for both internal and external purposes (e.g., tax reports, bank reports).

Compliance Objectives: Ensure the business operates within the legal framework and relevant regulations (business law, tax law, labor law), as well as internal policies and procedures, to avoid penalties and reputational damage.

These objectives are closely interconnected and mutually supportive, forming a solid foundation for the sustainable development of the business.

2.3 Models of Internal Control

To systematize and guide the design, operation, and evaluation of IC, various professional organizations and scholars have developed different frameworks and models. Among these, the **COSO Model** is the most widely recognized and influential globally, becoming a benchmark for best practices.

2.3.1 The COSO Model (COSO Integrated Framework)

The Committee of Sponsoring Organizations (COSO) first issued its Internal Control – Integrated Framework in 1992 and updated it in 2013 to better suit the modern business environment. The COSO 2013 Model defines IC as comprising five interconnected components, operating to achieve the three main objectives of an organization:

Control Environment: The foundation of the entire IC system, setting the tone and control culture within the organization. It encompasses integrity and ethical values, commitment to competence, oversight responsibility of the board, management's philosophy and operating style, and organizational structure with clear assignment of authority and responsibility.

Risk Assessment: The process of identifying, analyzing, and managing risks (including fraud risks and changes) that could impede the achievement of organizational objectives.

Control Activities: Specific policies and procedures established to ensure management directives are carried out to mitigate risks. These include activities such as authorizations, reconciliations, verifications, independent checks, safeguarding of assets, and segregation of duties.

Information and Communication: Focuses on identifying, capturing, and communicating timely, relevant, and quality information to enable personnel to fulfill their control responsibilities. This includes both internal and external communication.

Monitoring Activities: Activities that assess the quality of the IC system's performance over time, ensuring controls are operating as intended and are modified as needed. This includes ongoing and/or separate evaluations, and the communication of deficiencies.

These five components interact and support each other, forming a unified and integrated IC system.

2.3.2 Other Models

Besides COSO, other IC models exist, such as the **CoCo Model (Canada)** and the **Cadbury Report (UK)**. However, in the context of IC research, particularly in Vietnam, the COSO Model remains the most widely used framework for analyzing and evaluating IC effectiveness due to its comprehensiveness, logical structure, and flexible applicability.

2.4 Effectiveness of Internal Control

Evaluating the effectiveness of an IC system is essential to determine whether it is actually operating as expected and delivering value to the business. The effectiveness of Internal Control is understood as the ability of the IC system to consistently and reliably achieve its stated objectives. It goes beyond merely having processes and policies; crucially, these processes and policies must be effectively executed and yield the desired results.

According to the COSO framework, an IC system is considered effective when its five components are present and functioning effectively. "Present" means the components and relevant principles are established within the business's IC system. "Functioning effectively" means these components are operating as designed and achieving the IC objectives.

Key criteria for evaluating IC effectiveness generally include:

Achievement of operational objectives: Minimizing waste, optimizing resource utilization, increasing efficiency, and timely prevention and detection of fraud/errors.

Reliability of reporting: Financial and non-financial information is accurate, complete, timely, and reliable.

Compliance: Strict adherence to legal regulations and internal policies, reducing legal risks.

In the SME context, evaluating IC effectiveness becomes more complex due to resource and structural limitations. However, identifying and measuring effectiveness remains a critical challenge, requiring flexibility and assessment criteria tailored to the unique characteristics of each SME.

3. Factors Affecting Internal Control Effectiveness in the SME Context

This section will deeply analyze the factors affecting IC effectiveness, with a particular emphasis on the specific characteristics within the SME environment.

3.1 Factors Related to the Control Environment

The control environment forms the foundation, creating the overall atmosphere and control culture within the organization.

3.1.1 Commitment of Leadership/Owners

The **commitment of leadership and owners** is a crucial and decisive factor for IC effectiveness. Leadership shapes the control culture through their actions, words, and decisions, encouraging employee compliance. They also allocate resources (financial, human) for IC. For **SMEs**,

where power is often concentrated in the hands of the owner-manager, this commitment becomes even more critical. While concentrated ownership can reduce agency conflicts (as per **Agency Theory**), it can also increase risks due to the lack of objectivity if the owner-manager lacks awareness or commitment to IC. Proper understanding of IC benefits is key to system success.

3.1.2 Competence and Ethics of Personnel

The **competence** (professional knowledge, skills) and **ethics** (honesty, integrity, responsibility) of personnel are indispensable elements of the control environment.

Competence: SMEs often face difficulties in attracting and retaining talent due to budget constraints. Employees frequently perform multiple roles, requiring diverse competencies but also posing risks when one person executes and controls the same transaction. The lack of professional training programs is also a challenge.

Ethics: Ethics act as the first line of defense against fraud. In SMEs, close personal relationships can weaken controls due to deference. The lack of effective whistleblowing channels and the necessity of a strong "tone at the top" from leadership to foster a culture of integrity are notable characteristics.

3.1.3 Organizational Structure and Assignment of Responsibilities

A clear organizational structure and proper assignment of authority and responsibility are core to the control environment.

Organizational Structure: SMEs typically have flat, less hierarchical structures, reducing administrative costs and speeding up decision-making. However, simple structures also inherently carry control risks due to the absence of specialized departments (e.g., internal audit) or widespread overlapping duties.

Assignment of Authority and Responsibilities (Segregation of Duties): This is a fundamental control principle to prevent fraud and errors. However, due to limited personnel, SMEs often struggle to implement this principle (e.g., one person handling sales, cash collection, and record-keeping), creating significant "gaps" in IC. Therefore, **compensating controls** (e.g., direct oversight by the owner) become extremely important.

3.2 Factors Related to Risk Assessment

Risk assessment is a vital component in identifying threats and analyzing their likelihood and impact. SMEs often face difficulties in this process due to:

Limited knowledge and experience: SME owners and managers may lack in-depth knowledge or structured experience in risk management. Many SMEs lack formal risk identification processes, often relying on intuition or reactive measures. Insufficient data collection systems also hinder effective risk identification.

Limited analytical tools and methods: SMEs rarely use quantitative tools or methodologies for risk analysis, often relying on intuition. Constraints in dedicated risk management personnel and a tendency to focus on short-term risks are also weaknesses.

Limited response and risk management capabilities: Many SMEs lack concrete plans to respond to, mitigate, or transfer risks. Implementing control measures to reduce identified risks requires resources that SMEs often lack. A dynamic business environment also necessitates frequent risk updates, which SMEs may not handle effectively.

3.3 Factors Related to Control Activities

Control activities are specific policies and procedures implemented to mitigate identified risks.

3.3.1 Specific Control Procedures

Many SMEs may not fully establish or formally execute basic control procedures like authorization, approval, reconciliation, asset counts, and asset protection. The perfunctory nature of process documentation and overlapping duties (as mentioned) reduce the effectiveness of segregation of duties – a paramount control activity – increasing fraud risks.

3.3.2 Application of Information Technology (IT)

The level of IT application in SME management and accounting is often low. The reliance on manual record-keeping or simple, unintegrated software can increase errors and complicate data collection and reconciliation. While IT has significant potential for automating controls, enhancing security, and improving data accessibility, the initial investment costs and lack of IT-skilled personnel are major barriers for SMEs.

3.4 Factors Related to Information and Communication

Information and communication are the lifeblood of IC, ensuring high-quality information is collected, processed, and communicated timely.

Information Quality: SMEs often struggle to ensure the accuracy, completeness, timeliness, and relevance of financial and non-financial information. This can stem from manual recording processes, a lack of integrated information systems, and personnel competency issues.

Internal Communication System: Communication within SMEs is often informal, carrying risks of incomplete, inconsistent, or misinterpreted information. A lack of clarity regarding responsibilities and effective feedback mechanisms reduces the early detection of control deficiencies.

External Communication: Weak IC can hinder the ability to communicate transparent and compliant information to external parties (tax authorities, banks), leading to legal issues or loss of stakeholder trust.

3.5 Factors Related to Monitoring Activities

Monitoring activities are the final component, assessing the quality of the IC system over time to ensure its continuous effectiveness.

Lack of Independent Monitoring: Most SMEs lack a dedicated internal audit department due to resource constraints. Monitoring activities are often performed by owner-managers or senior managers, which can lead to a lack of objectivity and limitations in time and specialized expertise. SMEs also infrequently use external audit services.

Lack of Structured Monitoring Procedures: Monitoring activities are often spontaneous and unsystematic, lacking specific schedules. SMEs may not have clear key performance indicators (KPIs) or criteria to evaluate control effectiveness, or formal mechanisms for reporting and remediating identified deficiencies.

Limitations in Technology-Assisted Monitoring: Infrequent use of data analytics software to automate monitoring, and a reliance on manual monitoring, results in time-consuming, error-prone, and less comprehensive oversight.

3.6 Other Specific Factors of SMEs

Beyond the COSO components, several other specific factors inherent to SMEs significantly influence IC effectiveness:

Size and Ownership Structure: Their small size, limited personnel, and concentrated power in the owner's hands, along with prevalent family-owned structures, can lead to inadequate segregation of duties and risks of bias in controls.

Organizational Culture: In many SMEs, decisions are often based on personal relationships and trust rather than strict adherence to documented procedures, making IC formalistic or disregarded. Many SME owners also lack full awareness of IC's long-term benefits, viewing it as a cost rather than an effective management tool.

Cost of Implementing IC: SMEs often operate with tight budgets. Investing in IC (process development, training, software, consulting) is frequently perceived as a costly endeavor that doesn't yield direct profits, making them hesitant to invest.

External Factors: Legal regulations, government support policies, and specific industry characteristics can either promote or hinder the establishment and maintenance of IC.

4. Conclusion

This study has provided a comprehensive theoretical overview of internal control and a deep analysis of factors affecting its effectiveness within the SME context. The analysis indicates that IC effectiveness in SMEs is influenced by numerous factors, stemming from both the five core COSO components (Control Environment, Risk Assessment, Control Activities, Information and Communication, Monitoring Activities) and specific characteristics such as size, ownership structure, organizational culture, cost pressures, and external factors. For an IC system in an SME to be truly effective, it requires not only the establishment of documented processes and procedures but also a strong commitment from leadership, competent and ethical personnel, along with the identification and mitigation of the unique limitations inherent to the SME model. Understanding these factors provides a solid foundation for SMEs to design, implement, and maintain an appropriate IC system, thereby enhancing operational efficiency, mitigating risks, and contributing to sustainable development.

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