

An Exploratory Study of Internal Control and Fraud Prevention Measures in SMEs

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ABSTRACT

Small business and entrepreneurship has emerged as an important area of research over the past 40 years. This paper revolves around the issues of the internal controls and fraud prevention measures on SMEs performance. The level of fraud incidence as reported by owners is still at a very low level and the overall cost incurred is still within expectation. However, there is a question of whether the low reported rate of fraud is due to adequate preventive actions currently employed by owners, or whether the owners are reluctant to reveal the truth in order to portray their efficiency and effectiveness in running their businesses. This conceptual paper attempts to analyze relevant literature on internal control, fraud, current trends on fraud and business crime prevention measure adopted by SMEs. Based on the literature, a future research could be suggested in the context of Malaysia. It is hoped that future research in this aspect will uncover the relationship between the effectiveness of internal control within SMEs and to gauge the adequacy of fraud prevention measure taken by owners of SMEs in Malaysia. It is expected that effective internal control and the presence of appropriate fraud preventive measures will help to improve SMEs performance.

Keywords: Internal Control, Fraud and Prevention Measures, Small and Medium Enterprises

1. INTRODUCTION

Small and medium enterprises (SMEs) are much more vulnerable proportionally to fraud by employees, and much less able to absorb these losses than large corporation. The entrepreneur's principal objectives are profitability and growth, the business is characterized by innovative strategic practices and continued growth and may be seen as having a different perspective from small business owners in the actual development of their firm [1]. Contribution from SMEs to the Malaysian economy is also very important. They provide indirect support or income to economic growth. SMEs are also able to provide goods and services the same as large companies do albeit in smaller quantities. SMEs play a vital role in the Malaysian economy and are considered to be the backbone of industrial development in the country [2]. There is always an increase in the interest to establish SMEs because of small firms generating most new employment; the public favoring on small business; knowledge on entrepreneurship at high schools and colleges; the growing towards self-employment as well as small business being

attractive to people of all ages [3]. The research will be focusing on the effect of internal control and fraud prevention measures on SMEs performance.

2. RESEARCH BACKGROUND

The Association of Certified Fraud Examiners (ACFE) of the United States (1998) reported that businesses employing less than 100 persons were the most vulnerable to fraud and abuse by employees. According to KPMG's Fourth Fraud Survey Report Malaysia 2009, it is showed that a significant number of respondents believe that fraud is a major problem for businesses in Malaysia. 61 percent of respondents expect the level of fraud to increase over the next two years. In addition, 89 percent believe that the trend of fraud as well as financial statements fraud (78 percent) will significantly rise as a result of the economic crisis which took place in 2008. The value of fraud reported in the survey period was RM63.95 million. Not all respondents disclosed information on the number of fraud incidents or the value of fraud detected (15 percent of the 85 respondents responded they were victims of fraud were unsure of the number of incident whereas 53 percent were unsure of the value of financial losses due to fraud).

Hence, this suggests that losses may be far bigger than the disclosed amounts of the 56 percent of respondents who reported some form of recovery of assets that were misappropriated, 43 percent reported partial recovery while 13 percent reported full recovery. On the other hand, the number of identity fraud (when the person knowingly or intentionally obtains personal identifying information of another person and using it) victims increased by 12 percent in 2009 and the amount of fraud increased by 12.5 percent. This is the highest rate of increase in the seven years that the company has been issuing the report since 2002. New account fraud represents 39 percent of all 2009 fraud cases, versus 33 percent in 2008. Many of these fraudulent accounts were opened online. New account fraud is not limited to credit card accounts. Fraudulent cell phone accounts make up 29 percent of total new account fraud. Existing credit cards are also highly targeted, making up 75 percent of fraud attacks on existing accounts. This indicates that fraud and theft was rampant, and statistics show the rate increasing from year to year (for last seven years). If this problem is not addressed from an early stage then it will lead to huge losses to owners of SMEs.

Most of the studies and researches done on internal control and fraud against SMEs were mainly US-based. Not many studies have been conducted on the Malaysian environment. The total numbers of SMEs in Malaysia in the year of 2005 based on survey was conducted by the Department of Statistics; SME Corp Malaysia, showed that there were 514,079 active establishments of SMEs in the manufacturing and services sectors out of the 552,849 companies registered with the Companies Commission of Malaysia (CCM).

| Type | Number of Establishment | Share (%) |
|-------------------|-------------------------|-------------|
| Micro | 434,939 | 78.7 |
| Small | 100,608 | 18.2 |
| Medium | 12,720 | 2.3 |
| Total SMEs | 548,267 | 99.2 |
| Large | 4,582 | 0.8 |
| Total | 552,849 | 100 |

Source: Census of

Establishment and Enterprises, 2005 by Department of Statistics, Malaysia

TABLE 1: Number of Establishment of SMEs

Based on Table 1, the total number of establishment was 552,849, and 99.2 percent were SMEs. Out of this number, a total of 86.6 percent is made up from services sector (comprises of wholesale and retail, restaurant and hotel, professional services, transportation and

communication). It is followed by the manufacturing sector by 7.2 percent (consists of textiles and apparels, metal and non-metallic products and food and beverages) while the agriculture sector is made up from 6.2 percent (includes plantation and horticulture, fishery and poultry farming).

An appropriate definition of SMEs is essential as it will give various advantages to SMEs as well as for policy makers and supporting agencies in nurturing the SMEs sectors. In determining the best definition of SMEs, both quantitative and qualitative criteria should be met in order to represent the true nature of SMEs [4], [5]. According to Small Medium Enterprises Corporation Malaysia, SMECorp (previously known as SMIDEC), Malaysian SMEs can be defined according to size, annual sales turnover, number of full time employees as well as the activities run by the enterprises. Furthermore, the definition of SMEs in Malaysia is divided into three categories namely; Micro-enterprise, Small-enterprise, and Medium-enterprises. The detail is depicted in Table 2.

| Category | Micro-enterprise | Small-enterprise | Medium-enterprise |
|--|--|--|---|
| Manufacturing, manufacturing-related services and agro-based industries | Sales turnover of less than RM250, 000 OR fewer than five full-time employees. | Sales turnover between RM250, 000 and RM10 million OR between five and 50 full-time employees. | Sales turnover between RM10 million and RM25 million OR between 51 and 150 full-time employees. |
| Services, primary agriculture and information and communication technology (ICT). | Sales turnover of less than RM200, 000 OR fewer than five full-time employees. | Sales turnover between RM200, 000 and RM1 million OR between five and 19 full-time employees. | Sales turnover between RM 1 million and RM 5 million OR between 20 and 50 full-time employees. |

Source: SMECorp (Formally known as SMIDEC), (2000)

TABLE 2: Definition of SMEs in Malaysia

In addition, internal control and fraud can be considered as emerging issues among SMEs. It is worth to note that fraud is not actually a new issue. It has been a problem to SMEs before and continues to be until now. In other words, it is an old issue, but the form of fraud in SMEs has been evolving over time. There might be some differences between frauds perpetrated in 1970s and those committed in 1990s and in 21st century especially due to extensive use of sophisticated information and communication technology (ICT). Further details on internal control, risk management and fraud will be discussed in the following section.

2. LITERATURE REVIEW

It is emphasized that the factor is rarely examined as having a possible impact on failure of SMEs are internal control and fraud [6]. In Malaysia, research related to this area is still at a 'primitive stage' on SMEs performance. This issue is rarely highlighted and Malaysians seem to regard this as a sensitive one. As a result, they tend to put this matter aside, even though the real problem of fraud does exist in the Malaysian business environment. The purpose of this paper is to gather literature to propose an appropriate study on internal control and fraud prevention measures in Malaysia. It is also hoped that the paper could help to identify the level of SMEs owners' awareness on fraud and to assess how serious is the fraud affecting the SMEs in Malaysia. If this issue is neglected, it may badly affect the performance of SMEs. This would result in an

unhealthy phenomenon in this country, which could harm the growth of SMEs. Consequently, the root of the problem which contributes to the insolvency of SMEs will not be uncovered and the owners of the businesses are unaware that they are repeating the same mistakes over their business lifecycle. In other words, this study is able to enhance the understanding of the public at large and more specifically the owners of SMEs towards fraud and how to tackle the issue accordingly.

2.1 Internal Control

Internal control is a broad term with a wide area of operation [7]. It includes a number of methods and measures, which are exercised by the management to ensure smooth and economic functioning of business entity. It assists the management in the performance of various functions. Furthermore, internal control is a whole system of controls for the business entity on financial and non-financial, established by the management in the conduct of a business including internal check, internal audit and other forms of control [7].

Thus, it is apparent that internal control expression is used in a wide sense and includes internal check and internal audit besides other forms of controls. Besides that, internal control is a process designed and affected by those charged with governance [8], management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operation and compliances with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any these objectives.

Similar definition was stated by Committee of Sponsoring Organisations (COSO) of the Treadway Commission in a report (1992) entitled *Internal Control - Integrated Framework* [9]. Effective internal control system provides a way to meet its stewardship or agency responsibilities. For example, management must maintain controls which may provide reasonable assurance that adequate control is exist over the entity's assets and records. This can be accomplished by developing internal controls that require employees to follow company policies and procedures such as proper authorization for transactions. Such internal control system not only ensures that assets and records are safeguarded but also creates an environment in which efficiency and effectiveness is encouraged and monitored. It is becoming more important as entities automate their information system and they operate more globally [10].

Previous studies found that effective internal control in SMEs have led to the success of the business and it is also a fundamental and important step in reducing employee theft [11], [12]. For example, the implementation of internal control is fulfilled by follow-up or oversight the employee functions by delegation of their duties. Internal control also was effective on SMEs and it is a tool to measure the SMEs performance [13] and within a firm, better internal control should yield more reliable on internal data such as inventories, payables and performance measure, thus leading to better internal decision making, improved operations, and lower employee fraud [14], [15]. Strong internal control system strengthens enterprise governance, allows management objectives to be achieved and mitigates the risk of fraud by increasing employee perception of detection [16].

Normally control is the main task of executives either owners' or managers and these control is important as part of internal control on SMEs performance [17]. In a typical small business, the executive is in a better position to exercise control over the organization activities than his counterpart in a larger business. The executive should be aware of employee activities which may in high possibility of fraud occurrence such as incoming orders, production and shipping schedules, receipts goods, cash receipts and disbursements and customer complaints. Another key element of executive controls is the approval of transactions. Even though the executive may not be able to review or approve all the transactions and documents related to these transactions, at least he or she should consistently identify types of transactions, amounts of transactions, credit practices and inventories policies [17].

Effective internal controls are essential no matter how small the company for many valid reasons. Fraud prevention, embezzlement detection, and accurate financials are all reasons to justify for good internal control practices. Implementing controls into the financial accounting software alone is not enough to ensure compliance because it takes some people's power too [16]. Since most small business owners have very little accounting background, accountants are expected to play a key advisory role in helping a business design and implement sound internal controls [15]. Many private companies are benefited from implementing internal control provisions relating to accountability, independent audits, internal controls and document retention.

Internal control can provide reasonable, not absolute, assurance that the objectives of SMEs will be met [14]. The concept of reasonable assurance implies a high degree of assurance, constrained by the costs and benefits of establishing incremental control procedures that can lead to high performance of SMEs. Effective internal control implies that the small business generates reliable financial reporting and substantially complies with the laws and regulations that apply to it [13]. However, whether a small business achieves operational and strategic objectives or not may depend on factors outside the enterprise such as competition or technological innovation. Therefore, effective internal control provides only timely information or feedback on progress towards the achievement of operational and strategic objectives, but cannot guarantee their achievement.

2.2 Fraud

According to the Institute of Chartered Accountants of England and Wales (ICAEW) (2001), fraud is generally defined in the law as an intentional misrepresentation of material existing fact made by one person to another with knowledge of its falsity and for the purpose of inducing the other person to act, and upon which the other person relies with resulting injury or damage. Fraud may also be made by an omission or purposeful failure to state material facts, which nondisclosure makes other statements misleading. Fraud, however, is not an easily defined term. According to District Judges Association US, the definition may change depending upon the statute in which the word appears. For example, in the crime of conspiracy to, "defraud" include a dishonest obstruction of a government agency. The definition can also be reflective of particular precedent in a jurisdiction. In some cases the definition of fraud may not be limited to fraud methodology, but may also include the harm or consequences of the fraudulent conduct [18].

To constitute fraud, the misrepresentation or omission must be made knowingly and intentionally, not as a result of mistake or accident, or in negligent disregard of its truth or falsity. Also, the plaintiff must prove that the defendant intended for the plaintiff to rely upon the misrepresentation and/or omission; that the plaintiff did in fact rely upon the misrepresentation and/or omission; and that the plaintiff suffered injury or damage as a result of the fraud [10]. Damages may include punitive damages as a punishment or public example due to the malicious nature of the fraud. There are many state and federal laws to regulate fraud in numerous areas. Some of the areas they are most heavily litigated include consumer fraud, corporate fraud, and insurance fraud.

Employees in SMEs will commit fraud when they have opportunity to do so [19]. There are two separate but related theories about why employees commit fraud [19]. Based on the study conducted by Hollinger and Clark on 12,000 employees in the workforce, it was found that nearly 90 is percent engaged in "workplace deviant", which included behaviour such as goldbricking, workplace slowdowns, sick time abuses and pilferage [19]. In addition, one-third of employees actually had stolen money or merchandise on the job. A second theory about why employees commit fraud is related to financial pressure. In the late 1940's criminologist Donald R. Cressey interviewed nearly 200 incarcerated embezzlers, including convicted executives. He found that the majority committed fraud to meet their financial obligations. Cressey observed that two other factors had to be present for employees to commit fraud. They must perceive an opportunity to commit and conceal their crimes, and able to rationalise their offenses as something other than criminal activity.

Small business normally does not have internal auditing staff. Touche Ross (1974), Kapnick (1975) and Foster (1975) reported that in most of fraud cases they studied, effective internal auditing staffs was absent [20]. Psychological theory suggests that where there is an organisation (such as an internal auditing staff) that provides some deterrent or fear of being caught, the opportunity to commit crime is decreased. Poor internal control system also increases opportunities to commit fraud. In most instances, it was posited that poor internal control contributes to management fraud [20]. The surest avenue to fraud prevention and detection is a proper system of internal control, conscientiously implemented by management and must be regularly reviewed by auditors. Arens and Loebbecke (1976) and Kapnick (1975) suggest that a firm with poor accounting records is more susceptible to fraud compare to one that does not [20].

Basically there are several types of fraud could occur in SMEs and theft is one of the major fraudulent activities. Therefore, theft is always a serious problem for small business. In 2005, total retail losses were close to USD40 billion [21]. Because of the extent of the problem, many national merchandising businesses add 2 to 3 percent to their prices to cover the cost of theft, but even this may not be enough to compensate for the total loss. The two major types of theft are theft by outsiders (usually known as shoplifting) and theft by employees. Shoplifting is a major hazard of retail establishment [21]. Professional shoplifters, not amateurs and kleptomaniacs (a mental illness in which they have a strong desire, which they cannot control, to steal things) cause the greatest prevention problems. The amateur may be a thrill seeker who takes an item or two to see whether or not he or she can get away with it. The kleptomaniacs have an uncontrollable urge to take things, whether needed or not. Business owners and managers are often shocked by the techniques people use to remove merchandise from their premises, and by the people who do it. A new twist on shoplifting is high-tech. For example, shoppers purchase inexpensive items and reproduce the bar code. While shopping at a later date, they pasted the copied bar code to expensive items and then paid the cheap price. These high-tech criminals then resell it on the web [21].

According to John Warren, an Associate General Counsel for the Association of Certified Fraud Examiners (ACFE), employee theft is the single most expensive form of crime [22]. It may range from the simple act of an individual who takes only small items (such as pens or paper clips) to raids by groups that remove truckloads of merchandise. Furthermore, it is reported that, one out of every 33 employees is accused of theft each year [23]. Sometimes employees conspire with outsiders to steal from their employees, for example, by charging the outsiders a lower price or by placing additional merchandise in accomplices' packages.

Research has shown that employees who think their income is too low, or stagnating, steal more often and in greater amounts than other employees. A study showed that those who steal tend to be young, full-time employee operating alone, and that they steal merchandise more often than cash. A classic study found that the high turnover rate among temporary employees can cause serious security problems [24].

The most prevalent types of fraud are likely to be those that impact on the profit and loss account as a result of the overstatement of expenses or the understatement of income. These may not necessarily be large and so they may be difficult to identify. A time when an SME is particularly vulnerable to fraud is during a period of rapid expansion. The dynamics of the situation may mean that it is more difficult for managers to have an overview of the business. Advances in technological developments mean that all organizations that are connected to the internet are vulnerable to attack from outside. Whilst larger organizations may have the technical knowledge to minimize this threat, SMEs may not even recognize the risks. Whilst SMEs may not be able to have as many internal controls as larger organizations, it is imperative that their managers evaluate the risks that their businesses face and ensure that they at least have defenses in their key areas.

2.3 Current Trends on Fraud

Apart from traditional forms of fraud in small businesses, computer-related fraud comes into the pictures as a phenomenon brought about by advances in information-processing technologies. Before the invention of computers, fraud did occur but in different forms. The computer did not usher in a new wave of fraud, but it merely changed the form of older frauds, for example embezzlers can now steal by making electronic entries in books of accounts rather than pen and ink or electro-mechanical entries [25].

The largest threat to a computer system comes from within, with 85 percent of frauds being perpetrated by staff [26]. A study in the US estimated that the annual loss from computer fraud at USD3 to USD5 billion annually [27]. The survey of 1,200 security managers in the US was found that nearly 20 percent of the companies had detected a computer fraud within the five years covered, and that the rate of these frauds was directly related to the number of employees using computers [28]. This shows that employee fraud by using computers is a serious threat to business nowadays.

Owners of SMEs should be alert on current trends of fraud especially fraud related to information and communication technologies (ICT). Most of the owners of SMEs should be up-to-date with new knowledge on information technologies as well as tactics that could lead to failure of the businesses.

2.4 Business Crime Prevention

In order to prevent fraud in small business organizations, most previous literature suggested reviews on fraud prevention policy within company [29], company's internal control and attention on code of ethics amongst members of organization [30],[31]. In addition, some researches go further by proposing new ideas such as the implementation of fraud auditing and forensic accounting. These are attempts to minimize the likelihood of crime from occurring in small business organizations.

The greatest financial impact of fraud can occur in a small-business environment. A loss of 6% of revenues is significant for any company, however large, but a small operation whose margins are thin and reserves non-existent will go out of business [32]. Even if an operation survives the fiscal loss, its business continuity can be in jeopardy and it may no longer be able to function as an independent entity. Failing to address these issues places a company at a competitive disadvantage when fraud becomes a cost of doing business.

Fraud is a business risk in just the same way as an organization faces the risk of a customer becoming insolvent and unable to pay their debts [33]. The absence of an established policy means no position has been taken by the business. Therefore, the company has to come up with fraud prevention policy, for the business to communicate to its employees what is expected from them in terms of preventing, deterring and detecting fraud. Such a policy is essential as fraud prevention must always be proactive.

Welton and Davies looked at recommendation to focus attention on professional ethics within business organizations in order to minimize fraudulent activities [26]. They argued that high standards imposed from the top down can help raise the level of technical behavior within his business environment. They also concluded that an apparently strong internal control structure, without sound employee ethical behavior, is vulnerable. They suggested that business organizations should involve in continued efforts to keep employees aware of ethical issues. This may be accomplished by having in-house programs or requiring employees to attend a certain number of courses on ethics and ethical development.

Hunt emphasized on forensic accounting to prevent fraudulent activities in business organizations [29]. Unlike traditional auditing, forensic accounting is designed to detect and investigate fraud. The role of forensic accountants continues to expand as international white collar crime increases in scope and complexity. They will become the private investigators or detectives of corporate

governance and culture and deal with a variety of specialized functions in addition to investigating fraud, which includes asset tracing and recovery. Ideally, the existence of forensic accountants seems to benefit businesses, however, it costs the business more, especially to the small businesses with small amount of funds. Therefore, small business owners might not perceive hiring forensic accountants as important to their businesses.

When small businesses are victims of crime, they often react by changing their operation hours, raising their prices to cover their losses, relocating outside the community, or simply closing down the business. SMEs owners should take a hard look and aware of their businesses in areas such as physical layout, number of employees, hiring practices, and overall security to determine vulnerability to various kinds of crime, from burglary to embezzlement.

3. FUTURE RESEARCH

Fraud by employees could be serious and harmful to SMEs performance. Thus, SMEs must be ready to take appropriate actions to face the challenges and implications caused by fraud. Future research on this study should be able to uncover the relationship between the effectiveness of internal control and fraud preventive measures on SMEs and to gauge the adequacy of fraud prevention measures taken by SMEs in Malaysia. It is expected that effective internal control and the presence of appropriate fraud preventive measures will help to improve SMEs performance.

The future study may use a questionnaire as a tool to obtain feedbacks from respondents. The questionnaire may contain a section on demographic items such as gender, business age and number of employees. The next section could be on internal controls activities that are suggested to be in place in small and medium enterprises. The purpose of this section is to identify types of internal control that have been implemented by the respondents.

Apart from that, the following section may contain common fraudulent activities by employees in small and medium enterprises and the purpose of this section is to indicate the level of owners' concern on the type of fraudulent activities that occurred within their businesses. Another section also may deal with the best preventive actions taken by owners of SMEs that could prevent fraudulent activities within their business organizations.

There are several expected outcomes could be obtained from the study. The first possible outcome could be to prove that there is significant positive relationship between internal control and SMEs performance. This means that good internal control will lead to high SMEs performance. It is also expected that a high frequency of common fraudulent activities occurred in the past will lead to high level of owners concern on it. Thus, high level of owners' concern on common fraudulent activities will lead to high preventive actions to be taken by the owners.

4. CONCLUSION

As a conclusion, internal control and fraud prevention measures play a vital role and could have influence on SMEs performance. SMEs are much more vulnerable to fraud by employees because it is operated in a small scale where the owners invested only small amount of capital. Government, regulators, policy-makers, academicians and stakeholders should realize that SMEs are considered as the backbone of industrial development in Malaysian economy. Consequently, they should be more concerned towards the future growth and SMEs contribution to the whole economy. However, Malaysian SMEs should be prepared to face the highly challenging and globalised environment such as lack of financing, low productivity, lack of managerial capabilities, poor access to management and technology and heavy regulators burden. Government should also play their part by organizing training programs for entrepreneurs to equip them with relevant knowledge as an effort to increase the successful rate of SMEs established in Malaysia.

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In addition, internal control and fraud can be considered as emerging issues among SMEs. It is worth to note that fraud is not actually a new issue. It has been a problem to SMEs before and continues to be until now. The purpose of this paper is to gather literature to propose an appropriate study on internal control and fraud prevention measures in Malaysia. It is also hoped that the paper could help to identify the level of SMEs owners awareness on fraud and to assess how serious is the fraud affecting the SMEs in Malaysia. Internal controls are defined broadly as the measures an organization takes to protect life and property. Ranging from physical security and access controls to rules of conduct and procedure, internal controls do not guarantee elimination of the risk of errors or fraud. The main goal of internal control systems is to reduce the risk to an acceptable level. Preventive controls serve to stop error or fraud from occurring, and detective controls are intended to reveal inconsistency, error or suspicious circumstances. A third type, corrective controls, refers to controls implemented to mitigate losses or to make changes to existing policy. Segregation of duties is central to any internal control system. Internal fraud controls aren't fire-and-forget. Smart collaboration and ongoing improvement will help keep fraud in check. Here are the basics. There are several keys to effective fraud prevention, but some of the most important tools in the corporate toolbox are strong internal controls. Equally important, though, are the company's attitude towards fraud, internal controls and an ethical organizational culture. While internal auditors measure the effectiveness of internal control through their efforts, they don't generally assume ownership. They assess whether the controls are properly designed, implemented and working effectively and make recommendations on how to improve internal control.