

## **ABSTRACT**

Small and Medium enterprises (SMEs) is one of the biggest contributors to the economy. Economic survey 2009 statistics indicate a tremendous growth of small and medium scale Enterprises in Kenya over the last ten years; constituting about 98 per cent of all business enterprises in the country; yet 90 per cent of the business start-ups do not operate beyond their third anniversary. Specific studies focused on the relationship between the internal control systems and financial performance of SMEs in Homa Bay town. The main objective of this study was therefore to establish the relationship between the ICS and financial performance of SMEs in Homa Bay town, Kenya; Specifically establishing the effect of risk assessment on the financial performance of SMEs in Homa Bay town; Determining the relationship between internal control activities and the financial performance of SMEs in Homa Bay town; and establishing the relationship between audit communication and the Financial performance of SMEs in Homa Bay town. The research was based on the theory of inspired confidence and the agency theory. The research was conducted using both quantitative and qualitative approaches. The study employed correlation research design. The study used primary data which was collected by the use of structured questionnaires. The data was collected from both the managers and the owners and computed mean was used. The population of the study was 152 SMEs of which 20 SMEs were used during pilot study and a sample size of 132 SMEs used during the main data collection. Content Valid Index was used to test the instrument which was used for data collection, this did not form part of the final sample size. The CVI was 0.75 and for a research instrument to be valid, the CVI should be more than 0.7, below which the instrument is invalid hence the instrument was valid. Multiple regression analysis was used to analyze data. The results were presented using tables and graphs. The findings of this study are of benefit to SMEs managers and owners in employing ICS, the Government too can use this research in formulation of policies on SMEs and finally the research may stimulate academics and encourage further studies in the area of ICS and SMEs. From the results of the analysis, the findings show that the independent variables (risk assessment, control activities, audit communication) display a strong relationship for the study. There was a positive strong connection between the variables of the study as shown by 74.3%. The regression results also show that 55.2% of performance of small and medium enterprises in Homa Bay town, Kenya can be explained by internal control systems. This means that internal control systems help increase performance of small and medium enterprises in Homa Bay town, Kenya by 55.2 percent. The study concluded that there is a positive relationship between internal control systems and financial performance.