The Intervening Influence of Internal Controls on the Relationship Between Board Practices and Performance of Government Owned Entities in Kenya

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There is a growing public debate on the role of boards in government-owned entities due to poor performance, corporate scandals, and increased corruption. Good board practices and internal controls, including enterprise risk management, are crucial for enhancing performance. Research findings on their impact have been contradictory. However, improving transparency, accountability, and adherence to governance frameworks can positively influence performance. Addressing governance issues is crucial to mitigate resource mismanagement and corruption, leading to better overall performance. The objective was to determine relationships among board practices, internal controls, and government-owned entities' performance. Data was collected from 153 properly completed questionnaires out of the 157 returned, representing 65.38% of the entire population of 234 government-owned entities. The findings established that internal controls positively and significantly intervened in the relationship between board practices and performance. Implementing good board practices and internal controls promotes accountability and transparency, leading to enhanced organizational performance. Government-owned entities should prioritize implementing effective board practices and internal controls to enhance their overall performance.

Keywords: board practices, internal controls, performance, enterprise risk management, descriptive statistics

INTRODUCTION

Effective internal controls play a pivotal role in the performance of government-owned entities (GOEs) by sealing gaps in management systems that may lead to corporate scandals, wastages of resources and corruption (Oruke, Iraya, Omoro & Otieno, 2021). These controls include operational, financial and other procedures implemented by organizations to mitigate principal-agency conflicts and ensure positive returns for the business in addition to efficient operations (Tunji, 2013). The Committee of Sponsoring Organizations of the Treadway Commission (COSO, 1994) defines internal controls as comprising the control environment and activities, such as financial accounting reconciliations, undertaken by management to ensure integrity of its financial information.

Enron, Tyco, and WorldCom's collapse underscored the importance of good internal controls. Weak policies and control activities led to fraudulent financial reporting and accounting errors. Subsequently, the Sarbanes-Oxley Act was enacted, mandating internal control tests for publicly listed firms and holding directors and officers personally liable for financial statement integrity and accuracy (Tseng, 2007). Effective internal controls are crucial for resource utilization, efficiency, preventing wastage, and addressing corruption, as noted in the Transparency International report (2019). With corruption prevalent in the public sector, including GOEs, a robust internal control system can mitigate corrupt practices, enhancing transparency and organizational performance (Gachoka, Aduda, Kaijage & Otieno, 2018; Eniola & Akinselure, 2016).

Previous studies presented mixed results on the relationship between internal controls and organizational performance. Gachoka et al. (2018) found significant mediating effects of internal controls on the relationship between the budgeting process and organizational performance. Kinyua (2016) observed internal control systems' positive and significant influence on performance. Ibrahim, Diibuzie, and Abubakari (2017) found insignificant impacts of internal control practices on the performance of health institutions in Ghana. The study measured the control environment through management competence and adherence to ethical values.

Objective: To determine the intervening influence of internal controls to the relationships between board practices and performance.

Theoretical Framework

The study is anchored on Transaction cost and Agency theories. Transaction cost theory emphasizes proper arrangement of transactions and activities to reduce transaction costs through governance mechanisms. It also explains how internal controls address information asymmetry and opportunistic behavior (Macher & Richman, 2008). By considering benefits and costs, transaction cost theory provides a comprehensive perspective on organizational efficiency, evaluating whether the investment in internal controls justifies improved performance, making it a robust framework for analysis (Boulhaga, Bouri, Elamer & Ibrahim, 2023). The Agency theory on the other hand relates to interaction between two parties, one being the principal while the other referred to as the Agent. It is based on principal-to-agent relationships (Jensen & Meckling,1976). The theory predicts positive improved performance through effective implementation of internal controls and good board practices.

Literature Review

Sari's (2017) examination of state-owned enterprises in Indonesia revealed that effective internal controls positively influence corporate governance practices, reducing transaction costs associated with information asymmetry and opportunistic behavior. Eniola & Akinselune's (2016) findings in Nigeria details how a robust internal control system substantially diminishes fraud and enhances overall performance. Gachoka, Aduda, Kaijage and Otieno (2018) study on churches further demonstrated the significant impact of internal controls as an intervening variable on the relationship between budget processes and performance. Ariffin and Kassim's (2011) research on Islamic banks showed the positive influence of internal control practices on performance leads to reduced transaction costs and enhanced organizational efficiency. These studies highlight those effective internal controls play a crucial role in fostering governance, mitigating risks, and ultimately contributing to improved organizational performance across diverse contexts.

Hypotheses

H_0**:** *The internal controls do not intervene to the relationship between board practices and performance by government owned entities.*

Method of Analysis

The research methodology employed a positivist research philosophy, adopting a descriptive cross-sectional survey design to investigate the relationships among board practices, internal controls, and firm performance in government-owned entities (GOEs) in Kenya. The study population comprised 234 GOEs, representing all government-owned entities operating in Kenya as of December 31, 2022. 157 entities responded, representing 67.09 % response rate. Primary data on board practices and internal controls were collected through semi-structured questionnaires, while secondary data on performance indicators were obtained from annual performance contracting reports. The study utilized Covariance-Based Structural Equation Modeling (CB-SEM) with the AMOS application for data analysis, aiming to test the intervening effects of internal controls on the relationship between board practices and firm performance.

Study Variables

Board Practices had four sub-constructs: Audit committee practices, Gender Diversity and Mainstreaming, Board Accountability, Transparency, and Disclosure practices. The sub-constructs were measured using four practices on a five-point Likert scale. Internal controls had two sub-constructs categorized into control environment and financial control activities. The sub-constructs were each measured using four practices.

Results

The practices were measured on a five-point Likert scale. The results shown in Table 1 below established that government-owned entities in Kenya demonstrate commitment to integrity and ethical standards in their mandate (Mean = 4.86; SD = .430). The boards also oversaw the implementation of internal controls (Mean = 4.90; SD= .320). The findings also indicated that the organizations have implemented a human resources policy that promotes merit and competency (Mean = 4.78; SD= .678). The GOEs hold individual staff accountable for their internal control responsibilities and breaches (Mean 4.82; SD = .531). The study further showed government owned entities in Kenya have a highly effective control environment to a very large extent (Mean = 4.84). This was supported by a small standard deviation which indicated a minor variation in responses (SD = 0.489). Overall Cronbach Alpha value measuring internal consistency reliability was 0.863 which is above the minimum threshold of 0.7.

The item-total correlation scores were also above the recommended value of 0.3. EFA test further showed that factor loadings values above the minimum value 0.4 at 0.865, 0.853, 0.858 and 0.889, respectively. Items, therefore adequately satisfied the basic criteria for reliability and validity, hence fit to be subjected to further examination.

TABLE 1
CONTROL ENVIRONMENT

	Mean	Std. Deviation	Factor Loading	Item-Total Correlation	Cronbach's Alpha if Item Deleted
The entity demonstrates commitment to integrity and ethical standards in performance of its mandate.	4.86	.430	.865	.720 .828 .	
The entity's board provides oversight to the implementation of internal controls	4.90	.320	.853	.716 .852	
The organization has in place a human resources policy that promotes merit and competency	4.78	.678	.858	.764	.835
The organization holds individual staff accountable for their internal control responsibilities and breaches	4.82	.531	.889	.819	.778
Average	4.84	.489			
Overall Cronbach's Alpha 0.863					

Source: Primary Research Data, 2023

Financial Control Activities

The practices were measured five-point Likert scale. From Table 2 below, the findings showed that financial control activities are well documented (Mean = 4.89; SD= .336). The entities have proper internal checks for roles in internal processes, including payment system (Mean = 4.87; SD=0.392).

The organizations' budgetary controls are properly documented and communicated (Mean = 4.86; SD= .436). The study also established that GOEs developed and adopted control activities that contributed to mitigating financial risk (Mean =4.83; SD= .470).

TABLE 2
FINANCIAL CONTROL ACTIVITIES

	Mean	Std. Deviation	Factor Loading	Corrected Item-Total Correlation	Cronbach's Alpha if Item Deleted
The entity financial control activities are well documented	4.89	.336	.961	.925	.909
The entity has proper internal checks for roles in internal processes including payment system	4.87	.392	.946	.896	.908
The organizations budgetary controls are properly documented and communicated	4.86	.436	.929	.861	.918
The entity develops and adopts control activities that contribute to mitigation of financial risk	4.83	.470	.880	.792	.948
Average	4.86	.408			
Overall Cronbach's Alpha 0.939					

Source: Primary Research Data, 2023

Government owned entities were found to have good and strong financial control activities to a very large extent (Mean = 4.86). This was supported by a small standard deviation, indicating a low response variance (SD = 0.408). Overall Cronbach Alpha value measuring internal consistency reliability was 0.939. This was above the set criteria of 0.7, thus confirming data reliance.

The item-total correlations scores which were all above the recommended value of 0.3. The EFA test further revealed factor loadings that of 0.961, 0.946, 0.929 and 0.880, all above the minimum required value of 0.4. Therefore, the reliability and validity criteria were met and items retained for further statistical examination.

Factor Loadings

The loadings for the two indicators, control environment (CE) and financial control activities (FCA) were determined. The findings are presented in Table 3 based on the assessment of the two internal control practices indicators.

TABLE 3
FACTOR LOADINGS

Latent Variable	Indicators	Loadings
Internal Control	CE	0.79
	FCA	0.74

As indicated above table all two indicators had a factor loading above the recommended threshold of 0.4. The internal control environment had a factor loading of 0.79, while financial control activities loadings were at 0.73. Hence all were included in the model.

Construct Validity

The study utilized the Fornell-Larcker criterion to test for discriminant validity, ensuring three, namely board, control practices and organizational performance, were not interrelated. That was accomplished through the comparison of discriminant values extracted with the correlation values indicated Table 4.

TABLE 4
FORNELL-LARCKER TEST OF DISCRIMINANT VALIDITY IN INTERVENING EFFECT OF INTERNAL CONTROL PRACTICES

Variable	Discriminant Value	Board Practices	Internal Control	Organizational Performance
Board Practices	0.767	**0.767**		
Internal Control	0.888	0.570	**0.888**	
Organizational Performance	0.706	0.721	0.615	**0.706**

Results indicated that the discriminant value for board practices was 0.767, exceeding the correlation of board practices with internal controls (0.57) and organizational performance (0.721). Similarly, the study discovered that the discriminant value of internal controls was 0.888, exceeding correlation for internal controls with performance (0.615) and board practices (0.721). Thus, the findings confirm the discriminant validity. The standardized estimates depicting relationships amongst variables outlined by path diagram were determined

TABLE 5
STANDARDIZED REGRESSION WEIGHTS FOR THE INTERVENING RELATIONSHIP

	R	**R SQUARED**	**SE**	**T**	**P**
IC <--- BP	.644	0.415	.184	5.879	.000
OP <--- BP	.533	0.284	.108	4.454	.000
OP <--- IC	.388	0.151	.053	3.894	.000

As shown in Table 5, the findings indicated direct effect by board practices to organizational performance by government-owned entities in the absence of internal controls was positively significant (β=0.533; t = 4.454 > 1.96; SE=0.108, P-Value < 0.05) at five percent. In addition, it was determined that board practices' direct impact on internal control of government-owned enterprises in Kenya was significantly positive (β=0.644; t = 5.879 > 1.96; SE= 0.184; P-Value < 0.05) at 5 %.

Testing of Hypothesis

***H_2*:** *The internal control practices do not significantly intervene to the relationship between board practices and performance by government owned entities.*

The internal control practices significantly influence relationships amongst board practices with performances by government-owned entities. According to the results, internal control practices in government-owned entities positively impacted organizational performance ($\beta = 0.388$; $t = 3.894 > 1.96$; P-Value < 0.05) at a significance level of 5%. The influence of board practices on government-owned entities' performance decreases from 0.533 to 0.388 when internal control is considered an intervening variable. However, the effect remains significant ($t = 3.894 > 1.96$), suggesting that internal control plays an intervening role in relationships amongst board practices and entity performances. This demonstrates that internal control practices intervene relationship of board practices with organizational performance. Hence, the null hypothesis, that states internal control did not significantly intervene in the relationship of board practices indicators with performance in government-owned entities, was rejected. This implies that internal control practices do significantly intervene in the relationship of board practices with performance. However, the intervention is partial.

Discussion

The Internal controls encompass systems, processes, and policies designed to ensure financial reporting reliability, compliance with laws, and operational effectiveness. Robust internal controls, including mechanisms like segregation of duties, authorization processes, and regular audits, establish a framework that mitigates the likelihood of errors and fraud, ultimately enhancing overall operational efficiency.

Internal controls as a mechanism to ensure the effective implementation of board decisions, significantly contributing to achieving organizational goals and emphasizing the essential functions of ensuring appropriate resource utilization and risk mitigation. Various studies reveal the pivotal role of internal control practices in promoting transparency, accountability, and public trust in government-owned entities (Ariffin & Kassim, 2011, Sari, 2017; Eniola & Akinselune, 2016; Ibrahim *et al*. 2018, Gachoka *et al*. 2018). Internal controls facilitate informed decision-making by monitoring and providing feedback on the actions of management and the board, guiding the board towards areas that require improvement. This transparency is a crucial factor in attracting stakeholders, including investors, who contribute to organizational development. The empirical evidence suggests that a robust internal control system is integral to financial integrity and the overall governance framework of government-owned entities.

The study by Sari (2017) conducted in Indonesia reinforces the positive impact of internal controls on corporate governance practices and, consequently, improved corporate performance. This aligns with the findings of Eniola & Akinselune (2016) in Nigeria, where effective internal control systems are shown to substantially reduce fraud, thereby enhancing overall organizational performance. Similarly, Ibrahim et al. (2017) in Ghana and Gachoka *et al.* (2018) affirm the positive association between internal controls and organizational performance in the context of churches. Notably, the study by Gachoka *et al.* (2018) identifies an intervening effect by internal controls, addressing conceptual gaps in understanding their role in mediating the relationship between board practices and organizational performance.

Ariffin and Kassim's (2011) study on Islamic banks further corroborates the positive influence of internal control practices on performance. The findings collectively contribute to the academic discourse by establishing empirical support for affirming the theory's proposition that internal controls are instrumental in minimizing transaction costs and fostering efficient and effective organizational performance.

Conclusion

The empirical evidence presented in various studies affirms the critical role played by internal controls in ensuring enhanced organizational performance, particularly in the context of government-owned entities. The robust theoretical foundation emphasizes the necessity for organizations to adopt internal controls to minimize transaction costs stemming from errors, wastages, fraud, and inefficiencies. This study shows the pivotal role of internal controls as a mechanism for ensuring the effective implementation of board decisions, contributing significantly to achieving organizational goals.

Moreover, the findings demonstrate that internal control practices play a crucial intervening role in the relationships between board practices and organizational performance in government-owned entities. These practices act as a safeguard, ensuring appropriate resource utilization and risk mitigation, thus promoting efficiency and accountability. The positive associations identified in the studies highlight that effective internal control implementation contributes to improved corporate governance, transparency, and public trust in GOEs.

The empirical evidence further emphasizes that a well-established internal control system is integral to financial integrity and the overall governance framework of government-owned entities. By monitoring and providing feedback on management and board actions, internal controls facilitate informed decision-making and guide improvements in areas that need attention. This transparency becomes a key factor in attracting stakeholders, including investors, contributing to organizational development.

Recommendations

1. Organizations should prioritize robust internal control systems for effective operations and cost reduction in achieving organizational goals.
2. Organizations should adopt an integrated approach to corporate governance framework that includes effective internal controls and board practices to enhance their performance.

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