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**THE ROLE OF INTERNAL CONTROLS AND CAPITAL STRUCTURE IN THE
RELATIONSHIP BETWEEN GOVERNMENT OWNERSHIP AND FINANCIAL
PERFORMANCE OF STATE ENTERPRISES IN KENYA**

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Abstract

The primary objective of this study was to examine the impact of government ownership, internal controls, and capital structure on the financial performance of state enterprises in Kenya. The theoretical framework employed in this study encompassed various theories, including the Agency Theory as the foundational theory, complemented by the Management Control Theory, Trade-Off Theory, and the Public Choice Theory. A positivist philosophy was adopted, along with a longitudinal research design, to investigate the subject matter. The study population consisted of 62 state enterprises, and secondary data was utilized for analysis. The researcher employed both descriptive and inferential statistics to analyze the collected data, employing regression analysis and other statistical tests to test the formulated hypotheses. The combined influence of government ownership, internal controls, and capital structure was determined to have a significant impact on financial performance. The implications of these findings are expected to provide valuable insights for managerial practitioners within state enterprises, facilitating their comprehension of the integration of various factors affecting financial performance in the midst of a challenging economic environment. Furthermore, it underscores the significance of effectively managing core business processes to foster investor confidence within the country. In turn, the government bears the responsibility of ensuring economic stability, thereby facilitating the provision of internal controls and an appropriate capital structure through interventions that support investors in generating dividends from their investments in state enterprises.

Key words: *Government Ownership, Internal Controls, Capital Structure, Financial Performance, State Enterprises in Kenya.*

Introduction

Contemporary literature in corporate finance focuses on three pivotal areas that govern management behavior and operations. These factors, namely ownership, capital structure, and internal control, play a crucial role in establishing robust governance mechanisms that positively impact enterprise value (Agbenyo, Jiang, and Cobblah, 2018). Given the significance of alternative governance systems, where government ownership serves as a control mechanism, the relationship between ownership structure and firm performance has garnered attention from academics, investors, and policy officials alike (Abiodun, 2020). Government ownership can serve as a tool to regulate managerial self-interest and align it more closely with business objectives, thereby enhancing financial performance (Suhardjanto & Ajibroto, 2017). However, the research on the relationship between government ownership and company performance is limited, and no consistent pattern in this relationship has been identified. This lack of uniformity could be attributed to the fact that government-controlled enterprises may pursue diverse goals, including maximizing value and promoting national welfare or other non-profit considerations (Gakhar & Phukon, 2017). The role of government ownership and its impact on financial performance remains a significant topic in finance literature, particularly in regions where governments play a prominent role in development (Kandil & Markovoski, 2018). Scholars widely acknowledge the importance

of institutional investors in firms, as they contribute to effective corporate governance, which is considered a key determinant of performance (Fama and Jensen, 1983). Government, as an institutional investor, represents a unique entity distinct from others, as it introduces effective internal control systems within organizations (Saleh et al., 2009; Choi et al., 2012).

Ownership also plays a critical role in determining the capital structure of a firm. It is the responsibility of firm management to establish an optimal capital structure that fosters owner's equity growth while minimizing risks (Ebaid, 2010). Extensive research has been conducted to explore the impact of government ownership on firm performance. However, government ownership alone may not fully explain the level of firm performance, suggesting that other factors, such as capital structure and internal controls, may reinforce or moderate this relationship. Capital structure, a fundamental concept in financial management, pertains to how a company finances its operations, the sources of its funding, and the allocation of financing items on its balance sheet. It specifically seeks to determine the ideal combination of debt and equity financing that influences a company's future growth, investment potential, working capital, and ultimately maximizes stakeholder returns, thereby maximizing firm value (Suhardjanto & Ajibroto, 2017). Management plays a crucial role in determining the optimum capital structure that promotes owner's equity growth while minimizing risks (Kamau, Mogwambo &

Muya, 2018). In the case of privately owned firms, their capital structure choices are driven by financial risks and potential tax advantages (Jinseon & Choi, 2016). Conversely, government-owned firms' capital structure is influenced by principals who may restrict borrowing by imposing stringent internal control mechanisms.

Internal controls are implemented by management to optimize the utilization of resources within an organization. These controls take various forms and serve to monitor activities, provide guidance to the board, and enhance overall governance processes (Akinleye & Kolawole, 2019). Additionally, internal controls ensure adherence to firm policies and procedures, which guide organizations in achieving and maintaining their goals (Committee of Sponsoring Organizations [COSO], 2013). Consequently, an institution's ability to maximize profits relies partly on the design and effectiveness of its processes and safeguards concerning accounting and financial reporting (Ndungu, 2013). Management decisions regarding the financial mix also influence a firm's optimal capital structure (Umer, 2014). Furthermore, Ebaid (2010) contends that a significant relationship exists between the composition of a firm's capital structure and its financial performance. Financial performance serves as a measure of how effectively a company utilizes its resources to generate income. Ongore (2011) emphasizes that assessing financial performance provides an objective evaluation of a company's operations in terms of its financial resources. It involves the process of valuing the outcomes of business operation policies in monetary terms, thereby

enabling an overall assessment of a company's financial health over time.

The focus of this study centers on state enterprises in Kenya. Despite a wave of privatization over the past three decades (World Bank, 2014a), state enterprises (SEs) continue to play a crucial role in the economic growth of both industrialized and emerging nations. However, the government's dual role as a regulator, enforcer of laws and regulations, and owner of SEs sometimes hampers their competitiveness and efficiency, despite their socioeconomic importance (Sturesson, McIntyre, and Jones, 2015). The effectiveness of SEs has long been hindered by the overlapping management and ownership roles of the government, as well as vague and indeterminate mandates. Consequently, underperforming SEs impede the growth of the private sector, hinder domestic financial markets, and deplete limited resources required to deliver essential services (World Bank, 2014).

Problem of Research

The existing body of research indicates a relationship between government ownership and financial performance, highlighting the importance of state enterprises (SEs), particularly in the commercial sector, in formulating financial policies to enhance their performance, including improvements in capital structure and internal controls (Mueni & Muturi, 2015). However, empirical studies have produced contradictory results regarding the nature of the relationship between government ownership and financial performance. According to the agency theory proposed by Jensen and Meckling (1976),

agency problems lead to financial constraints, increasing the sensitivity of debt and equity and thereby reducing financial performance. On the other hand, the trade-off theory suggested by Myers (1984) and Jensen (1986) postulates a positive relationship between capital structure and financial performance of firms. SEs are often perceived to exhibit poorer performance compared to non-state corporations, potentially because the government prioritizes social and political objectives over profit maximization. Nevertheless, the performance of SEs remains critical for the country's economic development (Ongeti, 2014).

Previous studies have shown a relationship between government ownership and financial performance. For example, Mule and Mukras (2015) found a negative relationship between capital structure and return on equity (ROE) and return on assets (ROA). Other researchers, such as Dineshkumar & Kogulacumar (2011), have identified a correlation between internal control and organizational financial performance, while some studies, such as Badara & Saidin (2014), have not found any effect of internal controls on the association between ownership and organizational performance. The conflicting findings reported in the literature indicate the need for further investigation into the measurement and interpretation of financial performance in the context of government ownership. Additionally, most studies have focused on listed firms, with none specifically targeting companies where the government holds varying degrees of control and ownership. Therefore, this study aims to contribute to the

ongoing debate by introducing capital structure as a moderating variable and internal controls as an intervening variable. The research question addressed by this study is: What is the impact of capital structure and internal controls on the relationship between government ownership and financial performance of state enterprises in Kenya?

Literature Review and Research Focus

The study is grounded in four finance theories: Agency theory (Jensen & Mecline, 1976), Trade-off Theory (Myers, 1984), Management Control Theory (Buerstaker, 1999), and Public Choice Theory (PCT) (Bucham and Tullock, 1986). Agency Theory, proposed by Jensen and Meckling (1976), is relevant to this study as it explains the relationship between agents and principals, and how ownership can mitigate agency conflicts through the implementation of internal controls. Asare (2006) argues that designing and implementing internal controls is a primary responsibility of governance bodies in achieving organizational goals. The choice of capital structure is crucial for firms as it allocates operating cash flow between creditors and shareholders, leading to potential agency conflicts (Hossain, 2016). Trade-off Theory, proposed by Myers (1984), elucidates the correlation between leverage and profitability. Management Control Theory (Buerstaker, 1999) examines the role of internal control in management and its impact on firm performance. Lastly, Public Choice Theory analyzes collective decision-making processes, asserting that boards act in the interests of the appointing authority. The interplay and interrelationships among government

ownership, capital structure, and internal controls concerning financial performance have been extensively addressed in the literature, both directly and indirectly. For example, Lai (2015) investigated the interaction between capital structure, investment behavior, corporate finance, and profitability of listed companies in Vietnam, using the Ordinary Least Squares (OLS) method for analysis. The study found that leverage positively and significantly influenced Return on Assets (ROA) when creditors effectively monitored a company's operations, leading to reduced wasteful investments, particularly in state-controlled firms.

The argument suggests that listed firms, especially those controlled by the state, have easier access to bank loans. Okuda and Nhung (2012) focused on the capital structure and investment behavior of listed companies in Vietnam, examining the influence of government ownership using panel data. The study revealed a positive impact of capital structure on investment behavior and highlighted the critical role of government ownership in determining capital structure and, consequently, profitability based on ownership structure and capital raised. Qiliang (2012) explored the interaction between state ownership, the institutional environment, and internal control quality among Chinese listed firms, employing the Internal Control Index (ICindex). The study found that state-owned enterprises (SOEs) controlled by local governments exhibited inferior internal control quality compared to SOEs controlled by the central government, while non-state-owned listed firms showed similar internal control quality. Furthermore,

superior internal control quality significantly and positively influenced firm profitability as measured by Return on Assets (ROA) and Return on Equity (ROE).

In a different context and conceptual framework, Thai (2017) investigated the ownership and capital structure of Vietnamese listed firms, utilizing a sample of 261 firms listed on the Ho Chi Minh Stock Exchange (HOSE) and employing pooled Ordinary Least Squares (OLS) analysis. The study concluded that state investment proportion had no associated effect on firm leverage and profitability. However, the study did not consider internal controls, and the analysis technique employed was pooled Ordinary Least Squares (OLS), whereas the current study incorporates internal controls using stepwise regression analysis. Another study by Agbenyo, Jiang, and Cobblah (2018) assessed the influence of government internal control systems on financial reporting quality in Ghana, using simple random sampling and correlation analysis. The study found that the internal control system significantly influenced reporting quality, depending on the capital structure in place, ultimately affecting firm profitability. The relationship between internal controls and profitability was found to be significantly positive. These earlier studies were conducted in different contexts and conceptual frameworks, warranting the need for the present study.

Methodology of Research

General Background of Research Methodology

This study employed a positivist philosophy and utilized a descriptive longitudinal design. The target population consisted of state enterprises in Kenya. Secondary data was used for analysis in this study. Data diagnostics were conducted to ensure that the data met the required threshold for further testing. Simple linear regression analysis was employed to test the research hypotheses. The general model used for predicting financial performance was expressed as follows: $Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \epsilon$.

In this model:

- Y represents financial performance,
- X1 denotes government ownership,
- X2 represents internal controls,
- X3 signifies capital structure,
- β_0 denotes the constant coefficient,
- β_1 represents the coefficient of government ownership,
- β_2 represents the coefficient of internal controls,
- β_3 represents the coefficient of capital structure, and
- ϵ represents the error term.

Sample of Research

In order to better understand how government ownership, internal controls, capital structure, and the financial performance of state companies in Kenya relate to one another, a pilot study for this study was conducted using a sample of seven SEs from the study population. Data was gathered through interviews, surveys, a careful examination of pertinent documents, and a

sample of state firms. The pilot study's first findings suggested that these variables interacted complexly, indicating the need for a more in-depth understanding of these relationships. Based on these preliminary findings, modifications to the research design, data collection tools, and analysis procedures were made in order to strengthen the primary study. The preliminary study provided an invaluable chance to improve the research approach, identify potential obstacles, and increase the general validity and dependability of the ensuing examination into the complex Government ownership dynamics and financial performance in Kenyan state-owned businesses.

Instrument and Procedures

A mixed-methods approach was used in the research instrument and procedures for this study. In order to learn more about government ownership, internal controls, capital structure, and the financial performance of state firms in Kenya, secondary data was first gathered from a variety of sources, including financial reports, annual statements, and government records. To guarantee the accuracy and dependability of the collected data, data diagnostics were carried out. The degree of the linkages between government ownership, internal controls, capital structure, and financial performance were examined once the data was obtained using statistical approaches, including simple linear regression analysis. The results of this study will be helpful for managers, stakeholders, and policymakers in improving the financial performance of state companies in Kenya.

Data Analysis

The secondary data analysis procedure encompassed a number of steps and statistical techniques. First, using diagnostic procedures like the Shapiro-Wilk test or the Kolmogorov-Smirnov test, the collected data on government ownership, internal controls, capital structure, and financial performance of state firms in Kenya were checked for normalcy. If it was out that the data were not normally distributed, suitable transformations or non-parametric tests would be taken into account. The Variance Inflation Factor (VIF) was used to determine whether there were any highly correlated variables among the independent variables that would have an effect on the analysis. Principal component analysis (PCA) would be used to address multicollinearity if collinearity was discovered, as would actions like deleting one of the highly linked variables. Data outliers were located using statistical methods including boxplots and z-scores. It would be checked for data entry errors or other abnormalities in any outliers

that significantly varied from the trend of the data overall, and any necessary measures, such as data correction or removal, would be taken. Analysis of variance (ANOVA) tests would be run to investigate the links between the variables and see whether there were any notable variations in financial performance based on the capital structure or level of government ownership. The degree and direction of the associations between variables might also be examined using correlation tests, such as Pearson's correlation coefficient.

Results of Research

The study first tested the hypothesis that H_{04a} : *There is no significant joint effect of government ownership, capital structure and internal controls on Return on Equity.*

The hypothesis was tested using multiple regression analysis. Results are presented in Table 1(a), (b) and (c).

Table 1: Results of Regression on ROE

<u>Variable</u>	<u>Beta Coefficients</u>	<u>t- value</u>	<u>Sig.</u>	<u>VIF</u>
Constant	0.188	.258	.798	
Government Ownership	1.048	6.434	.000	1.0565
Capital Structure	.214	1.273	.0213	1.006
Internal Controls	.042	.438	.0365	1.052
Adjusted R ²	.727			
F. Statistic	31.242			
Sig F. Statistic.	0.000			

Table 1 (a) Model Goodness of Fit on the Joint Effect of Government Ownership, Capital structure, Internal Controls and Return on Equity

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.867 ^a	.751	.727	.40051
a. Predictors: (Constant), Government ownership, Capital structure, Internal controls				

As presented in table 1 (a) above, 72.7% (Adjusted R² = 0.727) of variations in the ROE are explained jointly by government ownership, capital structure and internal controls.

Table 1 (b): Model Overall Significance on the Joint Effect of Government Ownership, Capital structure, Internal Controls and Return on Equity

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	15.034	3	5.011	31.242	.000 ^b
	Residual	4.973	536	.160		
	Total	20.007	539			
a. Dependent Variable: Return on Equity						
b. Predictors: (Constant), Capital structure, Government ownership, Internal controls						

Table 1 (b) presents that the model is statistically significant in explaining the joint effect of government ownership, capital structure and internal controls on Return on Equity specifically in state enterprises in Kenya, F = 31.242, P<0.05).

Table 1 (c): Regression Coefficients on the Joint Effect of Government Ownership, Capital structure, Internal Controls and Return on Equity

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.188	.730		.258	.798

	Government ownership	1.314	.204	1.048	6.434	.000
	Internal controls	.259	.203	.214	1.273	.0213
	Capital structure	.089	.203	.042	.438	.0365
a. Dependent Variable: Return on Equity						

Table 1(c) presents the findings using standardized coefficients, indicating the effects of government ownership, internal controls, and capital structure on Return on Equity (ROE). The results demonstrate that government ownership has a significant positive effect on the joint impact of capital structure and internal controls on ROE ($\beta=1.048$, $t=6.434$, $P<0.05$). Furthermore, internal controls show a positive effect on the joint impact of government ownership and capital structure on ROE ($\beta=0.214$, $t=1.273$, $P<0.05$), while capital structure exhibits a positive effect on the joint impact of government ownership and internal controls on ROE ($\beta=0.042$, $t=0.438$, $P<0.05$). The beta coefficients further elucidate the results, indicating that a unit increase in government ownership leads to a positive effect of 1.048 on ROE ($\beta=1.048$, $t=6.434$, $P<0.05$). Similarly, a unit increase in internal controls results in a positive effect of 0.214 on ROE ($\beta=0.214$, $t=1.273$, $P<0.05$). Lastly, a unit increase in capital structure yields an effect of 0.042 on ROE ($\beta=0.042$, $t=0.438$, $P<0.05$). These findings highlight the significant roles of government ownership, internal controls, and capital structure in influencing the financial performance of state enterprises in

relation to Return on Equity. Based on the findings, the null hypothesis H_{04a} that there is no significant joint effect of government ownership, capital structure and internal controls on Return on Equity of state enterprises in Kenya, is therefore, rejected.

The study further established the sub-hypothesis that H_{04b} : There is no significant joint effect of government ownership, capital structure and internal controls on Return on Assets.

The hypothesis was tested using multiple regression analysis. In the regression model, Return on Assets was the dependent variable, while government ownership, capital structure and internal controls were predictor variables. Results are presented in Table 2a,

Table 2. Results of Regression on ROA

Variable	Beta Coefficients	t- value	Sig.	VIF
Constant	0.133	.594	.554	
Government Ownership	1.228	13.283	.000	1.056
Capital Structure	.485	4.411	.000	1.006
Internal Controls	.101	1.146	.000	1.052
Adjusted R ²	0.694			
F. Statistic	79.469			
Sig F. Statistic.	0.000			

Table 2 (a)

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.838 ^a	.702	.694	.34805		
a. Predictors: (Constant), Government ownership, capital structure, internal controls						
ANOVA^a						
Model	Sum of Squares	df	Mean Square	F	Sig.	
1	Regression	28.879	3	9.626	79.467	.000 ^b
	Residual	12.235	536	.121		
	Total	41.114	539			
a. Dependent Variable: Return on Assets						
b. Predictors: (Constant), Government ownership, capital structure, internal controls						
Coefficients^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.133	.224		.594	.554

Government Ownership	1.517	.114	1.228	13.283	.000
Capital structure	.438	.099	.485	4.411	.000
Internal controls	.398	.086	.101	1.146	.000

a. Dependent Variable: Return on Assets

Table 2a presents the findings, demonstrating that 69.4% (Adjusted $R^2 = 0.694$) of the variations in return on assets (ROA) can be jointly explained by government ownership, capital structure, and internal controls. The results indicate that the model is statistically significant in explaining the collective impact ($F = 79.467, P < 0.05$). Furthermore, based on the standardized coefficients, the results reveal that government ownership has a positive effect on the joint impact of capital structure and internal controls on ROA ($\beta = 1.228, t = 13.283, P < 0.05$). Capital structure also exhibits a positive effect on the joint impact of government ownership and capital structure on ROA ($\beta = 0.485, t = 4.411, P < 0.05$), while internal controls demonstrate a positive effect on the joint impact of government ownership and capital structure on ROA ($\beta = 0.101, t = 1.146, P < 0.05$). The beta coefficient analysis reveals that an increase in government ownership leads to a significant impact of 1.228 units on ROA. Similarly, an increase in capital structure results in an impact of 0.438 units, and an increase in internal controls yields an impact of 0.101 units on ROA. These findings reject the null hypothesis H04b, indicating a significant relationship between government ownership, capital structure, and internal controls in influencing return on assets.

Discussion

The findings of the research provide valuable insights into the relationship between government ownership, capital structure, internal controls, and their impact on financial performance measures such as Return on Equity (ROE) and Return on Assets (ROA). Regarding H04a, which posited that there is no significant joint effect of government ownership, capital structure, and internal controls on ROE, the results indicate a significant relationship. The analysis revealed that government ownership has a positive effect on the joint impact of capital structure and internal controls on ROE. Additionally, capital structure and internal controls individually contribute to the joint effect of government ownership and capital structure on ROE. These findings suggest that these three factors collectively influence ROE and highlight the importance of considering their interplay for achieving favorable financial performance. Regarding H04b, which stated that there is no significant joint effect of government ownership, capital structure, and internal controls on ROA, the results contradict the null hypothesis. The analysis demonstrated that government ownership, capital structure, and internal controls have a significant joint effect on ROA. Specifically, government ownership, capital structure, and internal controls

individually contribute to the joint impact on ROA. These findings emphasize the combined influence of these factors on achieving improved ROA and support the notion that considering the interplay between government ownership, capital structure, and internal controls is crucial for enhancing financial performance.

Conclusions and Recommendations

The objective of this study was to assess the joint effect of government ownership, capital structure, internal controls, and financial performance. The regression model utilized Return on Equity and Return on Assets as dependent variables, while government ownership, capital structure, and internal controls served as predictor variables. The results demonstrated a statistically significant joint effect. Furthermore, each of the variables, namely government ownership, capital structure, and internal controls, exhibited individual significant variations in financial performance measures. Notably, the joint effect proved to be higher and significant compared to the individual effects of the variables, thus supporting the alternative hypothesis over the null hypothesis. This study highlights the importance of considering the influence of internal controls and capital structure in understanding the impact of government ownership on financial performance in Kenyan state enterprises. The findings contribute to the existing knowledge by providing insights into the magnitude of these effects and the relative ranking of variables in the decision-making process, thereby facilitating the development of innovative approaches for managing state enterprises.

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