African Journal of Commercial Studies (ISSN: 2958-2326)
Volume 2, Number 1, 2023 | pp 1 – 11

Effects of Internal Control Components on Revenue Generation among Corporations in Kenya

Gabriel Muchoki Mutua
mutuagabriel48@gmail.com

Abstract:
Most businesses have underperformed due to the ever-changing environmental forces that affect the operation of commercial enterprises. Strong internal control systems are necessary for the institutions to implement sound revenue collection practices. Regarding the link between internal control systems and revenue generation, actual research in this area is scarce. The main objective of this research was to determine the effects of internal control components on revenue generation in Kenyan companies. The specific objectives focused on the effects of control environments, risk assessment, and control activities in Kenya. Agency theory and stewardship theory will serve as the study's foundation. The study engaged in a literature review approach to find out whether there is a direct relationship between the internal control components and revenue generation. The study reached the conclusion that budgets heavily rely on revenue collection, which is essential to financial management. According to the report, management should continuously improve internal control procedures to keep the system current with expanding operational capability, regular internal training, and employee development.

Keywords: Revenue Generation, Control Environment, Risk assessment, Control Activities

DOI/ARK: ark:/69431/AJoCS.v2i1.1

1. Introduction

According to Frazer (2012), "internal control components" refer to all the policies and processes management utilizes to ensure the veracity of financial reporting, compliance with laws and regulations, and the effectiveness and efficiency of operational activities. Every person at work should be concerned with internal control because it exemplifies their moral duty to be aware of, follow, and hold themselves accountable for the organization's policies and regulations. The internal control component's main purpose is to aid with entity protection and promotion of its objectives. They also help to reduce risks, assure information correctness, and increase operation effectiveness.

Numerous firms are required to provide reports on the effectiveness of internal control over financial reporting, which compels them to create detailed documentation to support their certifications and statements. Internal control guarantees that operations are effective and efficient, financial reporting is reliable, and the organization is in conformity with all applicable laws and regulations. Kenya Revenue Authority also employs an internal control system in its operations through the use of a computerized accounting system that handles the issues of authorization and verification, key elements in risk assessment and auditing procedures, and ensures compliance with the rules and regulations governing corporate financial reporting. Muhunyo and Jagongo (2018) state that the growth of business units has promoted internal control since it promotes orderly business operations, including adherence to internal policies. Only with the right internal control in place can the completeness and correctness of accounting records and preparation be achieved. Sigilai (2016) states that the audit committee is responsible for keeping an eye on these controls and evaluating their overall performance. Revenue being part of what is included in financial reports makes it have a lucid connection with the internal control components installed. It is expected that strong internal control components will yield a good return on revenue as compared to a weak and inefficient one.

Revenue is the gross inflow of cash, receivables, or other consideration resulting from a company's normal business operation from sales of goods, provision of services, and usage of other enterprises' resources producing interest (Cascini, DelFavero, & Bezner, 2014). Revenue acts as a tool that indicates the performance of the company, as it is a reflection of the money a business makes when it sells goods or services to its clients. The ability to generate revenue solely comes from sales of products and services, and sometimes the revenue collected is not a true reflection of the actual revenue generated. This might be because of fraudulent activities by staff members, cyberattacks that bypass the revenue system firewall, poor revenue collection methods, poor financial reporting standards, etc. This thus demands a strong internal control system that will neutralize such risks and threats. Although there are many different internal components, for the sake of this study, internal control components will only include control environment, risk assessment, and control activities.

Financial management, which is concerned with the acquisition, financing, and administration of assets inside an organization, includes internal control components such as control environment, control activities, and risk assessment. A company where risk assessment, control environment, and control activities are well coordinated tends to have a positive effect on revenue generation. Lister (2010) states that the fall in a company's revenue leads to it borrowing more money to cover its expenses, which puts the company in serious debt, thereby jeopardizing its sovereignty. Numerous studies have been conducted in Kenya, but none show a direct relationship between revenue and internal control at major companies in Kenya. Maina et al. (2016) conducted research on how internal control affects how projects are implemented in the Kenyan county government. The researchers, however, only examined one aspect of internal control. This study focuses on the three components of internal control.

Muio (2012) examined how internal controls affected the financial performance of private hospitals in Nairobi and found a significant link between the effectiveness of the internal controls and financial performance. This thesis sought to expound on the relationship between revenue generated and internal control. Njui (2012) looked into how well internal control and audit promoted good governance in the Kenyan public sector and discovered that internal control and risk management had the greatest impact on corporate governance, while compliance and consultation had the least influence. Though various research was done relating to internal control, with some failing to include other aspects of its components and no direct relation between its components and revenue generation, this study therefore sought to provide a solution through a project aimed at. This study seeks to establish if the absence of internal control components contributes to the amount of revenue generated.

2. Theoretical Review

A theory is a formal description of the principles upon which a field of study is based, thoughts put forth to elucidate on a fact or event. This study used two theories to explain the relationship between the variables. The theories include Agency theory and Stewardship theory.

2.1 Agency Theory

Agency theory was created by Jensen and Meckling in 1976, and according to this theory, an agency relationship is a legal arrangement in which one or more people (the principal(s)) hire another person (the agent) to carry out a certain task on their behalf, giving the agent the power to make decisions. It is a theory that examines the interaction of two parties: management, who act as the agents, and the investors, who are the principals in this case. The agents perform specific tasks, and the principal agrees to pay the agent. Since managers are tasked with the responsibility of handling the firm's resources, they are exposed to and knowledgeable about the activities of the firm more than the investors. This imbalance of information makes it hard for the investors to monitor whether the agent is working to fulfill their interests or not.

Muhunyo and Jagongo (2018) state that agency theory sees businesses as crucial organizational structures for enforcing contracts, which are a means of exercising control that lessens agents' opportunistic behavior. According to the theory, a thorough contract is drafted to meet the interests of both the agent and the principal in order to balance their interests. The principal’s use of an expert and tools to keep an eye on the agent strengthens the relationship between them. Management must therefore engage in controls including budgetary processes, internal audit committees, bonus programs, monitoring, and disclosure procedures to try to balance the agent’s and principal’s desires and lessen information asymmetry (Dubihlela & Nqala, 2017).

This theory is applicable to this study since internal control is one of many strategies employed by investors to manage the agency problem by minimizing agency costs that have an impact on revenue and performance in an organization. Internal control reduces information asymmetry and investor risk by improving investors' ability to obtain critical information about the agent under management's actions. For this study, this theory was used to showcase the control policies that Kenyan companies have employed to harmonize the interests of the principal and the agent, thereby establishing whether agencies support the nature of the control environment, control activities, and risk assessment.

2.2 Stewardship Theory

Keay (2017) describes stewardship theory as a theory that asserts managers will use their resources responsibly if left alone. Donaldson and Davis developed this theory in 1991. Good stewards collaborate with others rather than work alone; they are also not motivated by their own interests, unlike agents who subscribe to the agency theory. From a steward's point of view, if work is done for the benefit of the business as a whole, the individualistic nature and opportunity of fulfilling one’s objectives and goals will be achieved in the process.

Contrary to agency theory, stewardship theory emphasizes senior management’s duty as stewards, integrating their goals into the firm as a whole rather than from an individualist standpoint. According to the stewardship concept, when a company’s objectives and goals are realized, stewards are happy and inspired. According to Argyris (1973), whereas stewardship theory recognizes the need for a framework that empowers the steward and allows maximal autonomy built on trust, agency theory views employees as economic beings, thereby suppressing individualism's desires. It places emphasis on the fact that, for the maximization of profits for shareholders, executives must act with greater independence. Since executives and managers are practitioners of their profession in their respective careers, in order to be perceived as competent stewards of their organization, they return money to investors in part to establish a positive reputation that will allow them to re-enter the market in the future with strong credentials for financing.

Muhunyo and Jagongo (2018) promulgate that stewardship theory does not highlight the necessity to incur monitoring or agency costs, which include creating an internal audit function, as can be seen from the foregoing theory of agency. With this much said, Donaldson and Davis (1991) also point out that combining these two views rather than keeping them apart improves returns, suggesting that management must find a compromise. The fact that managers of companies act as stewards of their respective institutions—owners, customers, suppliers, creditors, and employees—lends credence to this study from the steward theory.

3. Literature Discussion

3.1. Effects of Control Environment on Revenue Generation

The control environment shapes people's awareness, which determines the tone of the organization. The control environment serves as the foundation for all other components of the internal control system. It includes elements like management's philosophy and its operating style, the structure of the organization, the competence and dedication of the people performing tasks, auditors and directors, and the integrity and ethical values of personnel tasked with establishing, managing, and overseeing the controls (Ibrahim, 2017). An internal auditor is crucial to a company's internal control system, which evaluates the effectiveness of the organization. He also has a duty to make sure the organization is operating in a way that will enable it to meet its goals (Midecha, 2022). Additionally, the internal auditor is responsible for examining the accuracy of the entity's accounting records and internal control system (Kamau, 2022). The control environment displays the management philosophy and practices regarding the value of internal control in income generation. The historicity and culture of the organization also have an impact on the control environment, which has an influence on how the organization's operations are organized. This fosters a supportive environment for diligent management and internal control.

According to Sigilai (2017), revenue is the main source of fraud and abuse, therefore needing a robust, comprehensive internal control system for collecting revenue. An internal control system builds an organization's confidence in its capability to carry out specific tasks, prevent mistakes and losses, and ensure compliance with all applicable laws and regulations by monitoring and improving both the organizational and financial activities of the firm. The majority of internal control research is lacking since it does not consider the control environment and its components. According to Ahmed and Nganga (2019), a control environment improves by giving the principal more knowledge about the conduct of the agent, thereby minimizing information asymmetry, mitigating investor risks, and improving revenue generation and collection. This makes it easy to measure a corporate entity's financial success through how well it utilizes its resources to produce revenues.

Magu and Kibati (2016) state that the control environment is set up to assure the secure custody of all assets as well as to identify and protect against any fraud. Kenya Farmers Association (KFA) Limited is battling issues with cash flow, delayed financial reporting, and ineffective financial resource management. The outcome demonstrated a favorable correlation between KFA's limited financial performance and its internal control system. The control environment was responsible for 61.3% of the difference in financial performance. The report suggested hiring more graduates and encouraging management to devote more time to overseeing the internal control system.

3.1 Effects of risk assessment on revenue generation

Risk assessment is a critical task assigned to management in order to reduce unpleasant surprises. Identifying and analyzing hazards that could affect achieving goals is part of risk assessment. Management must develop control methods that reduce risk exposure to a minimum that is acceptable (Khalid et al., 2018). Risk assessment is the methodical evaluation of elements that may affect the likelihood that an organization's goals won't be met, referring to the discovery and evaluation of pertinent hazards related to accomplishing organizational goals (Khalid et al., 2018). Management in organizations must carefully assess risk levels and work to keep those risks within bounds. Therefore, it is up to management to install internal controls that guarantee efficiency, accuracy, and effectiveness of financial reporting, legal and regulatory compliance. This is accomplished by reviewing routine performance and evaluating the sufficiency and efficiency of the internal auditor department's controls (Shankar, Choudhary, & Jharkharia, 2018).

Since there is a strong correlation between risk assessment and revenue generation, changes in risk assessment will have an impact on how much money institutions are able to bring in. Therefore, where risk assessment is properly conducted, the amount of money collected increases. Furthermore, it was determined that internal control helps ensure the accuracy of both internal and external reporting, promotes operational effectiveness and efficiency, and aids in legal and regulatory compliance (Agbenyo, Jiang, & Cobblah, 2018). Njagi (2018) adds that institutions should evaluate and identify potential risks involved with accomplishing objectives to make sure that organizers identify and assess pertinent hazards related to attaining the set objectives. The evaluation makes sure that potential risks are reduced in accordance with the institution's generally recognized accounting principles.

Ahmadabadi and Heravi (2019) contend that risk assessment needs to be systematic and integrated into business practices. Additionally, the organization should foster a culture of risk assessment as an ongoing interactive process because of the dynamic nature of operating and economic factors affecting businesses. Internal controls must be modified to meet changing risk, and new conditions, windows, and risks must be identified and analyzed. Total risks must be considered in the value for money (VFM) analysis because they depend on the service delivery method chosen.

3.1 Effect of control activities on the revenue generation

Policies, practices, and other mechanisms installed to guarantee that management directions are correctly followed are referred to as "control activities." It is easier to decide how control activities should be carried out when procedural rules are properly and accurately documented. It also offers sufficient data for auditors to examine the overall effectiveness of the control system in financial management activities. It is the responsibility of external auditors to review the financial accounts and provide an assessment of whether they provide a true and fair view at year's end. On the other hand, internal auditors examine internal control mechanisms and provide management with advice. Internal auditors report to management, whereas external auditors report to those who utilize financial accounts (Kamau, Kariuki, & Musuya, 2017). This control activity makes sure that all required steps are taken to address risks in order to meet corporate objectives. Control activities take place across the entire organization and cover a wide range of tasks such as reviews of operational performance, separation of functions by employees, authorization, and verification, of which the majority are supported by the internal auditing function (Cantwell, 2019).

Awitta (2010) affirmed that control activities can assist businesses in ensuring that they have already taken steps to reduce losses in accordance with achieving their goals. In other studies, Nantunda et al. (2020) demonstrated how reviewing and validating internal controls and adhering to authorization processes had a favorable impact on financial performance. The research mentioned above demonstrates that a connection between organizational effectiveness and authorization exists, though the empirical findings were based on businesses in various industries.

Sigilai (2017) found out that the control environment had zero influence on revenue collection in Nakuru's level five hospitals in Kenya. To improve revenue collection, the study suggested setting revenue targets and installing accounting and management systems. Matamande et al. (2014) conducted research on the revenue authority of Zimbabwe's internal controls. The study's goal was to determine whether internal control implementation measures boosted productivity, increased inflows of money, and decreased revenue leakages. The study concluded that revenue collection is crucial to financial management and that budgets depend largely on it. The study recommended that the management should continually upgrade the internal control activities to keep the system well updated with growing operational capacity, regular in-house training, and staff development.

4. Summary and Conclusions

Since it ensures the protection of assets for the development of revenues, internal control is a topic of interest to the management and many stakeholders. The majority of the reviewed literature provides more comprehensive coverage from a broader perspective. Additionally, it is presumptively assumed that internal control is in place and that the concern only pertains to operational issues. Because the variables discussed in the literature are only measurable within the research areas, generalizations about the impact of internal control on all types of companies are not possible. Internal control is thought to be a private sector idea as opposed to one that applies to all companies, including those in the public sector. The majority of the study has focused on private companies, disregarding public organizations, which also have a responsibility to fulfill obligations to numerous shareholders, among other things. Reporting should be based on a value-for-money audit, which provides additional information about internal controls.

A lot of the studies that were discussed in the literature review did not explicitly discuss how internal control affects revenue generation in the Kenyan economy. There is a dearth of literature in the respective field, as some have failed to include important internal control components that are fundamentally important to the research and the results to be realized. The agency theory and the stewardship theory are the two ideas that served as the foundation for this study, as they lucidly show how the dependent and independent variables affect each other in a business structure such as the major corporations in Kenya. A discussion of the empirical research on the control environment, risk assessment, and control activities, which compose the three constraints of the internal control system, followed. The conceptual framework was then offered to highlight the independent and dependent variables and factors that affect each one of them. It also showed how each independent variable relates to the dependent variable, which constitutes the primary objective of the study. This marked the conclusion of this paper.

References

Agbenyo, W., Jiang, Y., & Cobblah, P. K. (2018). Assessment of government internal control systems on financial reporting quality in Ghana: A case study of Ghana revenue authority. International Journal of Economics and Finance, 10(11), 40-50. doi:https://doi.org/10.5539/ijef.v10n11p40

Ahmadabadi, A. A., & Heravi, G. (2019). Risk assessment framework of PPP-megaprojects focusing on risk interaction and project success. Transportation research part a: policy and practice, 124, 169-188. doi:https://doi.org/10.1016/j.tra.2019.03.011

Ahmed, S. O., & Nganga, P. (2019). Internal control practices and financial performance of county governments in the coastal region of Kenya. International Journal of Current Aspects, 3(v), 28-41. doi:https://doi.org/10.35942/ijcab.v3iV.59

Argyris, C. (1973). Personality and organization theory revisited. Administrative science quarterly, 18(2), 141-167. doi:https://doi.org/10.2307/2392060

Awitta, M. (2010). Effectiveness of revenue collection strategies at Kenya Revenue Authority in Nairobi. University of Nairobi. School of Business. Retrieved from http://erepository.uonbi.ac.ke:8080/xmlui/handle/123456789/13813

Cantwell, B. (2019). Are international students cash cows? Examining the relationship between new international undergraduate enrollments and institutional revenue at public colleges and universities in the US. Journal of international students, 5(4), 512-525. doi:https://doi.org/10.32674/jis.v5i4.412

Cascini, K. T., DelFavero, A., & Bezner, R. (2014). Corporate Revenue Miscalculations & The Impact On Stakeholders. Journal of Business & Economics Research (JBER), 12(2), 77-92. doi:https://doi.org/10.19030/jber.v12i2.8521

Donaldson, L., & Davis, J. H. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. Australian Journal of management, 16(1), 49-64. doi:https://doi.org/10.1177/031289629101600103

Dubihlela, J., & Nqala, L. (2017). Internal controls systems and the risk performance characterizing small and medium manufacturing firms in the Cape Metropole. International journal of business and management studies, 9(2), 87-103. Retrieved from https://dergipark.org.tr/en/pub/ijbms/issue/36089/405223

Frazer, L. (2012). The Effect Of Internal Control On The Operating Activities Of Small Restaurants. Journal of Business & Economics Research (JBER), 10(6), 361–374. doi:https://doi.org/10.19030/jber.v10i6.7027

Ibrahim, M. (2017). Internal control and public sector revenue generation in nigeria: an empirical analysis. International Journal of Scientific Research in Social Science & Management Studies, 2(1), 35-48. Retrieved from http://internationalpolicybrief.org/images/2017/SEPT-JOURNALS/IJSRSSMS/ARTICLE4.pdf

Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure. Journal of Financial Economics, 3(4), 305–360. doi:https://doi.org/10.1016/0304-405X(76)90026-X

Kamau, C. G. (2022). Considerations for Bridging the Audit Expectation Gap: A Desk Review. African Journal of Commercial Studies, 1(1), 1-8. doi:https://n2t.net/ark:/69431/AJoCS.v1i1.1

Kamau, C. G., Kariuki, S. N., & Musuya, D. N. (2017). Exploring the motivation behind leakage of internal audit reports (whistle blowing) in the public sector in Kenya. International Journal of Academic Research in Accounting, Finance and Management Sciences, 7(3), 48-57. doi:http://dx.doi.org/10.6007/IJARAFMS/v7-i3/3101

Keay, A. (2017). Stewardship theory: is board accountability necessary? International Journal of Law and Management, 59(6), 1292-1314. doi:https://doi.org/10.1108/IJLMA-11-2016-0118

Khalid, S., Shahid, M., Bibi, I., Sarwar, T., Shah, A. H., & Niazi, N. K. (2018). A review of environmental contamination and health risk assessment of wastewater use for crop irrigation with a focus on low and high-income countries. International journal of environmental research and public health, 15(5), 895. doi:https://doi.org/10.3390/ijerph15050895

Lister, R. (2010). Understanding Theories and Concepts in Social Policy. Chicago: Policy Press. Retrieved from https://books.google.com/books?id=5lhllYoUtfwC&printsec=frontcover&dq=Ruth+Lister+(2010),+Understanding+Theories+and+Concepts+in+Social+Policy&hl=en&sa=X&ved=2ahUKEwi1h93IiK78AhUUUqQEHbB3BSAQ6AF6BAgEEAI

Magu, J. K., & Kibati, P. (2016). Influence of internal control systems on financial performance of Kenya Farmers' Association Limited. International Journal of Economics, Commerce and Management, 4(4), 783-800. Retrieved from https://www.academia.edu/download/55551539/4446.pdf

Maina, A. G., Muturi, W., Atambo, W., & Nyamasege, D. (2016). Effect of Internal Control Systems on Implementation of Projects at County Government in Kenya.

Research Journal of Finance and Accounting, 7(12), 146-153. Retrieved from https://iiste.org/Journals/index.php/RJFA/article/view/31522

Matamande, W., Nyikahadzoi, L., Taderera, E., & Mandimika, E. (2014). The effectiveness of internal controls in revenue management: A case study of Zimbabwe Revenue Authority (ZIMRA)(2011-2012). Journal of Case Research in Business and Economics, 1. Retrieved from https://search.proquest.com/openview/d8a84c22b22c123082e69db2e8c261bf/1.pdf?pq-origsite=gscholar&cbl=237741

Midecha, A. (2022). Internal Auditor’s Role and Corporate Financial Performance in Kenya. African Journal of Commercial Studies, 1(1), 36–42. doi:https://n2t.net/ark:/69431/AJoCS.v1i1.6

Muhunyo, B. M., & Jagongo, A. O. (2018). Effect of internal control systems on financial performance of public institutions of higher learning in Nairobi City County, Kenya. International Academic Journal of Human Resource and Business Administration, 3(2), 273-287. Retrieved from https://iajournals.org/articles/iajhrba_v3_i2_273_287.pdf

Muio, A. K. (2012). The impact of internal control systems on the financial performance of private hospitals in Nairobi. University of Nairobi. School of business. Retrieved from http://erepository.uonbi.ac.ke/handle/11295/12857

Nantunda, L., Ddungu, L., Munby, J., & McCauley-Smith, C. (2020). The Influence of COSO Preventative Control Operations on Revenue Mobilization in Ugandan Schools. Open Journal of Business and Management, 8, 1587-1608. doi:https://doi.org/10.4236/ojbm.2020.84101

Njagi, A. W. (2018). Effect of internal controls on revenue collection of level five hospitals in Kiambu county. MBA Thesis, University of Nairobi. Retrieved from http://hdl.handle.net/11295/104701

Njui, R. W. (2012). The effectiveness of internal audit in promoting good governance in the public sector in Kenya. University of Nairobi. School of Business. Retrieved from http://erepository.uonbi.ac.ke/handle/11295/10592

Shankar, R., Choudhary, D., & Jharkharia, S. (2018). An integrated risk assessment model: A case of sustainable freight transportation systems. Transportation Research Part D: Transport and Environment, 63, 662-676. doi:https://doi.org/10.1016/j.trd.2018.07.003

Sigilai, D. K. (2017). Assessment of internal control systems effects on revenue collection at Nakuru Level Five Hospital. Doctoral Thesis, JKUAT, COHRED, Juja. Retrieved from http://ir.jkuat.ac.ke/handle/123456789/3505