EFFECT OF PUBLIC FINANCIAL MANAGEMENT PRACTICES ON PERFORMANCE IN KERICHO COUNTY GOVERNMENT, KENYA: A CRITICAL REVIEW

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ABSTRACT

This paper examines the scope to which public financial management practices influences financial performance in Kenya. The Constitution of Kenya, 2010 and the Public Finance Management (PFM) Act, 2012 have anchored public finance on the principles of accountability and clear fiscal reporting. Chapter twelve on PFM Act addresses the financing of the functions of the two levels of Government towards an equitable society based on openness, accountability and public participation in financial matters. The National and County governments have the responsibility of ensuring accountability in resource use. The involvement of the Auditor General, the Controller of the Budget, and the National Treasury result in a continuous process of monitoring of resource use for optimal performance. The central aim behind public financial performance is systematic and continuous evaluation of two levels of government so as to improve future performance on one hand and promote institutional learning and consequently, improve the quality of organizational decision making. Therefore, this article develops a conceptual framework that analyses the relationship between financial management practices and financial performance in Kenya with particular emphasis to county government.

Key words: Public finance management practices**,** Financial Performance.

1 Introduction

Public financial management is absolutely critical to improving the quality of public service outcomes. It affects how funding is used to address national and local priorities, the availability of resources for investment and the cost-effectiveness of public services. Also, it is more than likely that the general public will have greater trust in public sector organizations if there is strong financial stewardship, accountability and transparency in the use of public funds (ACCA, 2010). It is important for governments to get it right because it impacts on a broad range of areas including: aggregate financial management (fiscal sustainability, resource mobilization and allocation), operational management (performance, value-for money and budget management), governance (transparency and accountability) and fiduciary risk management (controls, compliance and oversight) (Parry, 2010). In addition, effective public financial management is important for decision making. Accurate financial information is often used as the mechanism to support decisions and ensure effective resource allocations. Public financial management is a complex field with many new initiatives and relatively few successes to date. Implementing public financial management reform is a challenge in all countries, but to successfully mount and execute public financial management projects in resource constrained countries; public financial management practices adopted should be the ones that are both effective and efficient.

1.2 Financial Performance

Financial performance refers to the degree to which financial objectives are being or have been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Public institutions in Kenya have traditionally been witnessed poor financial performance due to poor financial management practices characterized by: Poor controls and audit trails and systems documentation; Lack of system data checks and controls; Poor response time; Limited ability to generate reports and weak access security. Traditionally, financial management practices in government institutions are aimed at avoiding wastage and extravagant spending, and especially, the loss of resources through possible fraud, irregularity or improper spending. But the rise of New Public Finance Management, associated with neo-liberalism, has significantly reduced the emphasis given to public financial management regularity and probity.

1.3 Public Financial Management Practices

Buger and Woods, (2008) defines public financial management as an area that focuses on the prioritization and use of scarce resources, on ensuring effective utilization of public resources, and on attaining value for money in meeting the objectives of Government and in particular delivering services to the people. Correia *et al*, (2003) hold the view that, financial management forms part of the total operation of an organization and as such, it relates to the other functional disciplines in the organization.

Fung, (2012) defines financial management as being part of the decision-making, planning and control subsystems of an enterprise. It is considered to incorporate: the treasury function, which includes the management of working capital and the implications arising from exchange rate mechanisms due to international competition. It also incorporates the evaluation, selection, management and control of new capital investment opportunities.

Public financial management practices are a collection of sufficient resources from the economy in an appropriate manner along with allocating and use of these resources efficiently and effectively. The practices include resource generation, resource allocation, and expenditure and resource utilization. There are several components of financial management and include financial planning and control, financial analysis, accounting information, management accounting (pricing and costing), capital budgeting and working capital management among others (Fung, 2012).

Ahmed, *et al*, (2010), notes that financial management practices involve planning for the future of a business enterprise to ensure a positive cash flow. Financial management involves planning, organizing, directing and controlling the financial activities such as the procurement and the using up of funds of an enterprise. Therefore, from an institutional point of view, the process of financial management is associated with financial planning and financial control. Financial planning seeks to quantify various financial resources available and plan the size and timing of expenditures. In Kenya, Public Finance Management Act, 2012 focuses on the basics of financial management practices; such as the introduction of proper financial management systems, appropriations control and the accountability arrangements for the management of budgets. In Kenyan public sector, the management of resources is guided by principles of public finance. All public officers are expected to adhere to the principles in order to utilize the resources effectively. Article 201 of the Constitution of Kenya 2010 outlines the Principles of public finance as follows there shall be openness and accountability, including public participation in financial matters; the public finance system shall promote an equitable society, and in particular-the burden of taxation shall be shared fairly; revenue raised nationally shall be shared equitably among national and county governments; and expenditure shall promote the equitable development of the country, including by making special provision for marginalized groups and areas; the burdens and benefits of the use of resources and public borrowing shall be shared equitably between present and future generations; public money shall be used in a prudent and responsible way; and Financial management shall be responsible, and fiscal reporting shall be clear.

Public financial management is a complex field with many new initiatives and relatively few successes to date. Implementing public financial management practices is a challenge in all countries, but to successfully mount and execute public financial management projects in resource constrained countries has proven rather difficult. On one hand, “hard technical” requirements surrounding the full policy/budget cycle in modern public finance systems are fundamental when developing reform programs. On the other hand, “soft” institutional and organizational factors are of equal importance in the implementation of public finance management reform programs. Experience with reform programs indicate that it is often the “soft” factors that constitute real

barriers to successful reform (Danida, 2012). According to the revelations of the Auditor General's most recent report (KENAO, 2015), there are glaring inconsistencies in counties' financial probity that call for immediate action by the oversight bodies and mainly the Senate. Twenty-nine Counties were not able to account for their budget allocations and reported revenues remained low despite increased levies. The report highlights a web of mechanisms employed by county government officials to avoid accounting for public funds. Local revenues remain low in counties and waste, over-expenditure, shifting of funds to unbudgeted items, plus outright theft is endemic.

Reduced and unaccounted for revenues is one of the issues raised in the audit queries. For instance in Nairobi County, the report reveals that though the county generated Sh5.5 billion as revenue, only Sh5.2 billion was banked. This raises questions on the whereabouts of Sh. 252 million. This amount was not banked, neither was its expenditure approved by the Controller of Budget (C.O.B, 2016).Counties also failed to provide proper documentation on expenditure. For instance, In Kisii County, the assembly paid the MCAs Sh20 million for foreign trips yet they did not provide supporting documents. This includes claims made on the trips to China, Germany, Israel, United States and Uganda which had no backing in the form of invitation letters or passports to prove that the members travelled.

If wanton financial mismanagement of public resources is not checked the gains already made in fiscal devolution and public finance management will be eroded. The consequence of this will be non-attainment of County Integrated Development Plans (CIDPs), missed Millennium Development Goals (MDGs) and delayed Vision 2030. For this reason it is imperative that a study on effect public financial management practices on County governments' financial performance be undertaken. The study will review how financial planning, supply chain financial management, revenue mobilization as well as internal controls in county governments' impacts on financial health of county governments.

2 Theoretical Review

2.1 Agency Theory

Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as "the relationship between the principals, such as shareholders and agents such as the company executives and managers". In this theory, shareholders who are the owners or principals of the company, hires the agents to carry out the work. Principals delegate the running of business to the directors or managers, who are the shareholder's agents. Indeed, Padilla, (2002) argued that two factors can influence the prominence of agency theory. First, the theory is a conceptually simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested.

The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals. Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Padilla, (2002). The first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

In agency theory, the agent may succumb to selfish, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control. Davis, *et al*, (1997) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, but it does not eradicate or even minimize corporate misconduct. Here, the positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory (Davis, Schoorman and Donaldson, 1997).

2.2. Theory of Financial Control

The present and future personal functions of human beings are asserted to constitute the fundamental point of reference in a theory of financial controls. This theory stipulates that existing and possible functions of financial tools for organizations are most essential. In the same light, it is stated that, payments, financial instruments, accounting, control models, economic calculations, and related considerations, both within and outside of the organization, ought to be discussed in regard to inner characteristics but also possible effects. It is noted that establishing the relationships between various activities and financial processes, from a financial control point of view, is a general and basic issue (Joshi *et al*, 2003).

The theory of financial controls for organizations places a natural focus on the firms such that they are viewed from several latitudinal areas. The first regards the human beings' functions of what is accomplished through organizations, their activities and output. The second is about the structure of the organization and activities, and of transactions that various parties have with each other. The third area covers the control systems in the sense of recurring procedures and methods that are employed to relate present and future functions to resources both externally and internally. The aforementioned financial control tools are argued to be crucial from an individual organization's perspective and also for larger economic systems. The fourth and last area illustrates the specific processes of individual organizations for certain issues. The theory further states that structure and financial control system works together (Joshi *et al*, 2003). The financial control theory is very relevant to the current study given that it assists in better understanding of the intricacies surrounding financial management in an organization.

2.3 Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board of directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson *et al*, (1996) concurs that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.

It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival. According to Hillman, Canella and Paetzold (2000) directors bring

resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influential. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the communities influential are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

2.4 Public Budget Theory

In the early 1900s, budget reform was characterized by a switch from the established budgeting practice of the Legislative Budget to the Executive Budget. In 1921, the Budget and Accounting Act, which established an executive budget at the national level in the United States and became the foundation for present day budgeting at the federal level, was passed by Congress. The new executive budget was coupled with the new idea and practice of a line-item, or object-of-expenditure, budget (Correia et al, 2003). Line-item budgeting includes objects or lines of expenditure, such as personnel and supplies, which are the focus of development, analysis, authorization, and control of the budget. Governmental organizations often prefer line item budgeting as line-item budgeting allows budget officials to move money between line-items

Public budgeting is an integral part of the United States system of democratic government. Public budgeting refers to the political and technical process of matching and allocating monetary resources, such as taxes, fees for service, debt instruments, and funds from other levels of government, with individual and program needs. The public budgeting process serves a wide range of fiscal, administrative, financial, and governance purposes. Public budgeting may be seen as the place or process through which stakeholders' debate competing agendas, perspectives, and viewpoints about the public good or the common good. Budget actors or stakeholders may play multiple roles in the public budgeting process. For example, citizens serve the roles of voters, taxpayers, and clients. Multiple role expectations are common in democratic governments and societies (Lawson, 2012).

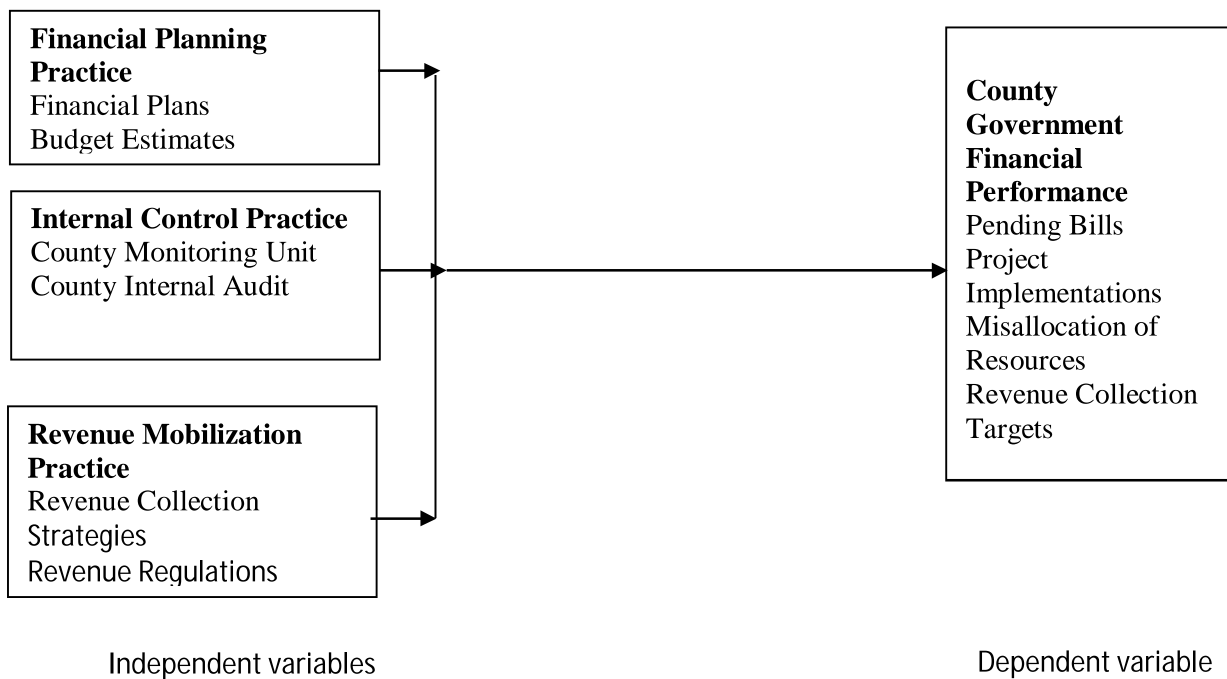
Public budgeting is the process that produces a public budget, a consensus of the best ways to allocate tax revenues to fund public programs that benefit the common good. Public budgeting is often referred to as a scarcity allocation problem. Public budgeting is used for purposes of promoting economic growth, employment, and income distribution. Public budgeting is considered to be a part of development economics in general and, more specifically, a part of economic planning (Correia et al, 2003). Public budgeting processes, and their related public budget documents, reflect the political and social conditions of their times. During the twentieth century, public budgets were alternately characterized by focus on financial control, managerial improvements, planning, prioritization, and accountability depending on the historical context. While public budgeting is a technical process, public budgeting is also a social and historical process.

Public budgeting occurs at all levels of government including national, state, and local levels. The 1997 U.S. Census of Government reported that in June 1997, there were 87,504 governmental units

in the United States. All of these governmental units undertake a public budgeting process. Some elements of public budgeting apply to the public budgeting process of all levels of government and some are level and region specific. Public budgets, at all levels of government, serve at least five major functions in society and government. Public budgets fund programs that are responsive to public needs. Public budgets fund programs that are effective in accomplishing stated goals. Public budgets fund cost-effective programs. Public budgets communicate to all stakeholders. Public budgets use the public budget to strengthen the economy. While size and scale of public budgets vary between levels and types of government, all public budgets involve the stages of development, adoption, implementation, and reconciliation (Correia et al, 2003).

3.0 The Conceptual Framework

The framework conceptualizes that public financial management practices (financial planning, internal controls, supply chain management, revenue mobilization and financial governance) influence on financial performance of county governments ascertained through pending bills, misallocation of resources, project implementations and revenue collection targets.



3.1.1 Financial Planning and Financial Performance

White, (2009 states that a budget process is a planning process for the operational activities of a firm. Burger and Woods (2008) also define a budget as a financial or quantitative statement prepared prior to a specified accounting period and containing the plans and policies to be pursued during that period. A budget is a financial plan that serves as an estimate of future operations, and, to some extent, as a means of control over those operations. Budget reform requires goals that are both good public policy and achievable. White, (2009), clearly explain the budget of Government as the operational plan that it presents to indicate how it will use financial resources to deliver services to the people.

Shah, (2009), states that budgets are important tools of financial management employed to direct and control the affairs of large and multifarious institutions. They are used not only by governments, where budgeting had its origins, but in other public bodies, in industry and commerce and in private families. A budget is a basic tool in management. It stipulates which activities and programs should be actively pursued, emphasized or ignored in the period under scope, considering the limited financial resources available to the organization. Any good budget process needs to attain three important objectives, namely, maintenance of fiscal discipline, attaining allocation efficiency, and operational or technical efficiency. Attainment of fiscal discipline has been the main goal of budget reforms. Enlargement of the legislature's role in budgeting is a new contemporary issue to budgetary approaches. With legislative budgeting, new responsibilities must be accommodated both to longstanding appropriation processes, and to political relations with government. Further, legislature's new role in budgeting cannot come from government's weaknesses. The budget is an end product of a lengthy process of monitoring and controlling public finances involving the treasuries and other agencies (Earl, 2000).

Kung e*t al* (2013); notes in their study that there is a positive relationship between budget planning and budget emphasis on the performance of the management as well as that of the organization. The aim of their study was to examine the relationship between budget planning, budget emphasis and performance. The study used a seven-pointer Likert scale to measure budget emphasis, budget planning and organizational performance. Furthermore, Joshi e*t al* (2003) did a study to determine the relationship between corporate budget planning, control and performance evaluation in Bahrain. They used a questionnaire to collect data relating to budget planning, control and performance from 40 companies that were listed on the Bahrain stock Exchange. The results of both studies indicated that there is a strong positive relationship between budget planning, budget emphasis and management performance.

3.1.2 Internal Controls Practice and Financial Performance

Internal control mechanisms is exercised at top management level, and entails a close study of the organization’s total effectiveness, productivity and management effectiveness . Control mainly involves the process through which a manager ensures that activities are carried out as originally planned (Bruyns *et al*., (1997) defines control as the process of checking to determine whether or not plans are being adhered to. The author further mentions two types of control: a priori control, which is the control that takes place before the task is undertaken, and an ex-post facto control, which is the control that takes place after the task has been undertaken. He also indicates that the utilization of the budget for financial control is a comparatively easy task: a comparison is made between the real amounts of money spent and the budgeted amounts. The controls in place to uphold expenditure management are very important, and can be used as a basis for determining the process of budgetary control on the route to accomplishing a desired goal, which can be linked to a certain outcome (McThomas, 2003)

According to Wanjara, (2015) in analyzing relationship between internal controls and financial performance he posited that, internal control is broadly defined as a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories; effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and

surprises along the way (Jenning *et al*., 2008).

Internal control involves an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals. Organizational performance comprises the actual output or results of an organization as measured against its intended outputs (or goals and objectives). It involves the ability of an organization to fulfill its mission through sound management, strong governance and a persistent rededication to achieving results. Effective nonprofits are mission-driven, adaptable, customer-focused, entrepreneurial, outcomes oriented and sustainable. Creating flexible, high-performing, learning organizations is the secret to gaining competitive advantage in a world that won't stand still. Performance measures can be financial or non-financial. Both measures are used for competitive firms in the dynamic business environment) (Jenning *et al*., 2008).

El-Nafabi (2009) sought to establish the role of public sector audit and financial control systems in safeguarding public funds in Sudan. He alleged that there are a number of factors that encourage financial corruption in the public sector. He asserted that financial control systems and internal check in majority of public sector units are weak and ineffective. This is claimed to be occasioned by a shortage or lack of qualified and trained accountants as exemplified by the allegation that in a public department, all the financial activities of the concerned organization are conducted by one or two employees. In addition, there is absence of internal auditing which is a crucial component of internal control system in most government departments. In case such exists, it is very weak and ineffective. It is also asserted that there are deficiencies in the accounting system in most public firms. Some of the cited challenges facing public financial management system include the allegation that the entire accounting system is manual at both national level and the states, and that about half of the staff have had no formal training in financial management.

Ashbaugh-Skaife and Collins (2007) uses data prior to audits mandated by section 404 of the Sarbanes-Oxley Act to investigate the economic factors that expose firms to internal control risks, the incentives to discover and report internal control deficiencies (ICDs), the effects of ICDs on earnings quality, and market consequences of making such a disclosure. Ashbaugh-Skaife and Collins (2007) found that, relative to those not disclosing deficiencies, firms making "early" ICD disclosures (i.e., prior to mandated audits) typically have more complex operations, recent changes in organization structure, more accounting risk exposure, and fewer resources to invest in internal control. Early disclosing firms are also more likely to contract with dominant audit suppliers, change auditors, and face greater monitoring by regulators and institutional investors. As to deficiency consequences, the results of our earnings quality tests suggest that firms disclosing ICDs typically report low quality financial information. In addition, market tests indicate that the market differentially responds to the disclosure of ICDs conditional on whether the market is already valuing firms from an abandonment option perspective due to their operating uncertainty.

3.1.3 Revenue Mobilization Practices and Financial Performance

County Government's local revenue is defined as subtotal of all categories collected from a number of sources. County Governments have two main sources of revenue namely; central government transfers and own revenues. Central government grants include equitable sharable revenue and conditional grants; while local county government revenues includes property rates, plot rent, contribution in leu of rates (CILOR), single business permits, quarry, bus park, car park, change of user fees, market dues, produces, penalties and fines, licensing fees among other charges or levies, (Alam et al., 201).

In Kenya, the Commission on Revenue Allocation (CRA) is mandated by the Constitution of Kenya 2010 under Article 216 to make recommendations concerning the basis for the equitable sharing of revenue raised nationally between the national and county governments and among county governments. The sharing among county governments is referred to as the horizontal share while the sharing between national and county governments is referred to as the vertical share. In the pursuit of its mandate as articulated in the constitution, the CRA in its first generational formula recommended five parameters to be used in the horizontal revenue sharing formula.
The CRA recommended the use financial responsibility parameter in order to encourage counties to manage their financial resources prudently and optimize their revenue-raising potential (CRA 9, 2012). The justification for the use of the parameter is also buttressed by one of the key principle of public finance as set out in Article 201 (d) of the constitution of Kenya which states that, “public money shall be used in a prudent and responsible way”. The parameter was also meant to incentivize counties to optimize on their own revenue raising capacity.
Domestic revenue mobilization over the past has been strengthened with key reforms in policy, institutional and regulatory framework being developed in the country. With the support of Commission of Revenue Allocation (CRA), county governments have now scaled up there efforts of automating revenue systems in order to seal loopholes in collection of revenues. This is because local revenue streams including fees and levies contributes significantly to the development agenda of counties as well as to the whole economy. The National Government through the National Treasury has partnered with various institutions such as African Development Bank in building capacity for revenue and resource mobilization through provisions of support in developing suitable governance mechanisms in order to manage revenue collections well.
As noted by Thomson and Strickerland (2007), strategies are at ends and these ends concern the purpose and objectives of the organization. They are the things that organizations do, the paths they follow and the decisions they take in order to reach certain points or level of success. It is the direction and scope of an organization over the long-term: which achieves advantage for the organization through its configuration of resources within challenging environment, to meet the needs of markets and to fulfill stakeholder expectations (business growth, financial performance and market leadership).

Noore, Alam, Nastiti, and Nur (2012), carried out a study on relationship between Regional Autonomy and Local Resource Mobilization in Eastern Indonesia. The paper addresses this question by focusing on Indonesia's most recent decentralization policy and assessing and analyzing the role of local government‘s resource 43 mobilization on service delivery. Fiscal decentralization empowers sub-national governments to raise sufficient revenue from local sources thereby reducing their dependence on the national government. Based on data collected from two different locations in Eastern Indonesia the study shows that the dependency of local authorities on central government is excessive and that the share of local revenue in regional budget has remained rather small. It also shows that while the fiscal power granted to local governments is limited, a combination of politico-economic and contextual factors has further undermined the prospect of revenue mobilization at the local level.

Previous studies carried out, for instance by Juul, (2006) on decentralization, local taxation and citizenship in Senegal, focused on the politics of revenue collection in a framework of decentralization, democratization and multiparty politics as experienced in the small village of Barkedji in the pastoral region of Senegal. In Senegal, revenue collection has recently been transferred from state administrators to locally elected councillors. Contrary to the assumption of the good governance doctrine, this transfer of responsibility has not resulted in a strengthening of

democratic structures where taxpayers demand public services and more political representation in exchange for increasing taxes. In Barkedji, as elsewhere in Senegal, tax compliance hit rock-bottom after tax collection became the responsibility of local councillors. Meanwhile other types of local 44 institutions, with less clear state relations, are able to mobilize large amounts of revenue outside the normal tax channels for the delivery service (Juul, 2006).

4.0 Conclusions and recommendations

This paper extensively considered the literature and the considerable opinion and reconstruction of public financial performance in Kenya. To ensure complete implementation of wide reforms in public sector and efficient and effective in management of public resources; effective budgeting for proper planning and controlling of scarce financial resources in the accomplishment of overall national and county goals; strengthen of internal control as tools for monitoring and evaluating resources and ensure optimal utilization. There is need for sensitization of other partners on devolution. A lot of resources will be devolved; the public should be able to check on what is happening. Citizens should be given a platform to exercise their rights and monitor implementation of projects. This should happen through civic education and sensitization at the community level.

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