

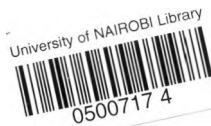
THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF
LOCAL AUTHORITIES IN KENYA

BY

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A RESEARCH PROJECT REPORT SUBMITTED TO SCHOOL OF BUSINESS IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE OF MASTER
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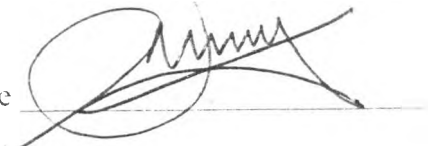
UNIVERSITY OF NAIROBI



OCTOBER, 2008


Declaration

This research project report is my original work and has never been presented for a degree in any other university.

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This research project report has been submitted for examination with my approval as the University Supervisor.

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Dedication

I dedicate this research report to my dear wife Mbinya, my daughter Serena, my employer, and colleagues at Mavoko Municipal Council for being supportive during the time of my studies.

Acknowledgement

I would like to acknowledge the support, advice and tireless efforts of my supervisor Mr. Olweny in the supervision during my research work and in writing of this research project report.

I would also like to acknowledge the assistance provided by the Head of Internal Audit and Town Clerks of the sample local authorities in securing the sample data used for the study.

I also thank the Librarians at the University of Nairobi for allowing me the use of the library facilities.

Finally, I would like to acknowledge the assistance given by the staff at the School of Business, University of Nairobi.

Abstract

The aim of this research was to determine the relationship between financial performance of local authorities and their corporate governance characteristics. The corporate governance practices studied included the frequency of meetings by the council, political composition of the full council, the role of internal audit, the role of the audit committees, the effect of managerial practices, and the size of the full council. The study applied a causal-comparative research design. The sample comprised of 30 local authorities adjacent to the greater Nairobi region. The data set comprised of both secondary and primary data. Secondary data was obtained from the offices of town clerks as well as the audited financial statements of the respective local authorities. The study sampled observations for the five-year period between 2002 and 2007. A structured data sheet was used to collect secondary data. A multiple regression model of financial performance versus corporate governance characteristics was applied to examine the relationship between the variables.

The study established that financial performance by the local authorities in Kenya is influenced by their political composition, the manner in which internal audits are conducted, and managerial approaches applied by the chief officers. This is further linked to failure by the councils to conduct regular assessment of their performance; poor coordination between the internal and external providers of assurance; and high staff turnover and transfers from within the top management of the councils. The findings have been found to concur to previous evidence from empirical studies on corporate governance.

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List of Abbreviations and Acronyms

CEO	:	Chief Executive Officer
CIPFA	:	Chartered Institute of Public Finance and Accountancy
GOK	:	Government of Kenya
IIA	:	Institute of Internal Auditors
LAS	:	Local Authorities
NPM	:	New Public Management
NPOs	:	Non-Profit Organizations
NSE	:	Nairobi Stock Exchange
RBM	:	Result Based Management
SOEs	:	State-Owned Enterprises
UNDP	:	United Nations Development Programme.

CHAPTER ONE

1.0 INTRODUCTION

1.1. Background to the Study

Corporate governance can be interpreted as the set of mechanisms – both institutional and market-based – that induce self-interested managers (controllers of the firm) to make decisions that maximize the value of the firm to its shareholders (Denis and McConnell, 2003). Corporate governance can also be defined as the set of institutional arrangements affecting corporate decision-making (Ball, 1998). Evans and Loh (2002) described corporate governance as “rules governing board structure, managers’ and boards’ incentive compensation, decision rights by the board and the chief executive officer (CEO), succession of the board and the CEO, share holding voting, debt/equity finance decisions as well as disclosure during takeovers.” Corporate governance of all organizations whether commercial, not for profit, or government (such as in local authorities or the public sector) is primarily about the interface of the Board of governance (the Council) and the Executive, and accountability to shareholders (citizens) (Johnstone, 2002).

There exist twenty two core principles of good corporate governance. They include: authority and duties of shareholders/owners; recognition & protection of the rights and obligations of the members; leadership; appointments to the board; strategy and values; structure and organization; corporate performance, viability and financial sustainability; accountability to members; responsibility to stakeholders; balance of powers; internal control procedures;

assessment of performance of the board & directors; induction, development & strengthening of skills of directors & the board; appointment & development of executive management; adoption of technology and skills; management of corporate risk; corporate culture; social and environmental responsibility; recognition & utilization of professional skills and competencies; corporate compliance; corporate communication; and, corporate governance reporting (Institute of Directors, 2002).

The corporate governance structure specifies the rules and procedures for making decisions on corporate affairs and provides the structure through which the institutional objectives are set, as well as the means of attaining and monitoring the performance of those objectives. Given the existing problems inherent in the corporate form, performance will be function of the quality of the corporate governance structures of the firm (Weisbach, 1993). Empirical studies have established that typical governance structures adopted by firms that influence performance result from changes in; board meeting frequency (Congen et al 1998); Board composition (Stapledon and Lawrence, 1996; Jense, 1997); insider share ownership (Morck, Shleifer, and Vishny, 1998); and executive compensation (Murphy, 1985; Conyon, 1997). Board meeting frequency potentially carries important governance implications as it is less costly for a firm to adjust the frequency of its Board meetings to attain better governance of the firm, than to change the composition of its board or ownership structures. Vafeas (1999) found that meeting frequency was influential in improving operating performance in a manner consistent with the agency theory.

All public sector bodies work through an interrelated system that brings together an underlying set of legislative requirements. Governance principles and management processes. Traditionally, this has conformed in whole or in part and in many different ways with the principles of good governance. In the case of local government, there strong regulatory framework and robust arrangements for monitoring and review are essential (Roe, 1998). Some of the governance structures above would need to be operationalized for purposes of studying how they influence their performance.

Nonprofit organizations include a great variety of organizations formed under specific state laws for certain non-commercial (i.e. not profit-oriented) purposes. These organizations are generally, exempt from income and certain other taxes they might otherwise pay. The financial strength of each organization is typically dependent on donations or gifts, although some organizations may also receive fees for service provided and/or earnings on endowments. The role of the governing body, or board, of nonprofit organization also varies greatly. In some cases the board will be an operating board, that is, one that actually does most of the work of the organization with little or no paid staff assistance. In other cases, the board is a governing board, with generally oversight responsibility and the day-to day operations left to a professional paid staff. Just like in the commercial sector. Good governance has become an issue of increasing importance to nonprofits (Society of Corporate Secretaries and governance Professionals, 2008).

Previous studies in Kenya have shown that there exists a relationship between good corporate governance and financial performance of firms. A study by Lang'at (2006) had sought to

determine if firms listed on the Nairobi Stock Exchange (NSE) change their corporate governance structures when experiencing performance declines. The findings established that there are positive relationships between listed firms' performance and frequency of board meetings, the ratio of outside directors to total directors, percentage of insider share ownership, and executive compensation. The study concluded that the way forward in examining corporate governance structures for Kenyan firms. Perhaps, might be increasing the focus on shareholder interest and concerns, and identification of some widely accepted guiding principles, rather than trying to find some specific structure which are universally applicable, for effective corporate governance.

A similar study by Gathura (2007) had sought to determine the relationship between various components of corporate governance and financial performance of manufacturing firms listed in the NSE. The key findings of the study revealed existence of a perfect linear relationship between various structures of corporate governance and financial performance of manufacturing firms listed in the NSE. Specifically, the findings revealed that there exists a perfect linear relationship between performance measures and the frequency of boards meetings. CEO compensation, board composition, and percentage of insider holding. This was achieved through a regression- based F-test on each of the four performance measures (Tobin's Q: Return on Equity: Return on Assets: and Price-to-earnings ratios) that were used. The study recommended that adoption of sound corporate governance practices is significant for the continued success of business for manufacturing firms.

Empirical studies on firm performance as a function of Board composition yield mixed results (Baysinger and Butler, 1985). Bricley and James (1987) for example, found that the proportion of outside directors is significantly lower on boards of banks in states that restrict banking acquisitions, suggesting that outside directors play a role in evaluating takeover proposals. Hermalin and Weisbach (1998) reported that executive compensation is more highly correlated with firm performance in corporations having a majority of outside directors than in firms that have a predominant insider board. Further, Hermalin and Weisbach (1998) found that outsiders are more likely to join a board after a firm performs poorly or leaves an industry. One inference may be the need for additional outside guidance in companies undergoing strategic shifts.

1.2. The Local Authorities in Kenya

There are four types of Local Authorities (Las) allowed under the Local Government Act and its subsequent amendments; City councils, municipal councils, town councils and county councils. The Local Government Act empowers the Minister for Local Government to establish local authorities. In total there are currently, 175 LAs comprising 3 cities (one actual-Nairobi-and two nominal ones-Mombasa and Kisumu), 42 municipalities, 63 town councils and 67 county councils (Republic of Kenya, 2008a).

The management structure of LAs is also a two tier system; policy organs and the executive structure. The policy making structure comprises of the council, council committees (mandatory and standing) and sub- committees. The executive structure consists of the Chief Executive Officer (Town Clerk, or Clerk to Council), the management team (chief officers, heads of departments, section or unit heads and support staff. The political leader in a Local

Authority is the Mayor for cities and municipalities or Chairman for town and county councils who is elected by Councillors from among themselves. The Mayor and Councillors form the Council which is a policy making organ. Each councilor sits on at least one of the various policy committees such as Finance and General Purposes, Town planning and Works committee, Environment Committee. These committees deliberate on issues before they are taken to Full Council Committee for ratification. The Town Clerk is the Chief Executive Officer and serves as the secretary to the council. The Clerk is assisted by various heads of departments and section heads (Republic of Kenya, 2008a).

Local governments, have the responsibility for the implementation of a large range of services such as roads, waste collection and local town planning. Councilors within each ward are elected by residents for five years. Residents pay council rates that supplement funds from the State government and the council is responsible for the management of those funds to provide a variety of services. Whilst different from some local government models in other countries, the local Government described as municipal or county councils provides a disparate range of services and is highly responsive to the communities they serve (UNDP, 2001).

Despite their apparent lack of independence and limited number of revenue options, the Kenyan local governments provide an impressive array of functions and services and are becoming increasingly important in the grassroots implementation of policy and service provision (Republic of Kenya, 2003). In the last two decades council responsibilities have

expanded to include services such as social and community welfare, economic development and environmental management.

1.3. Problem Statement

In Kenya, the Ministry of Local Government faces a number of challenges in its endeavour to achieve this mission emanating from both the internal and external environment. The challenges facing the Ministry include increased demand for good governance and improved service delivery, the poor image of the Ministry and Local Authorities in the eyes of various stakeholders, poor performance by the Local Authorities, the constraining legal framework and lack of adequate resources for service delivery in the sector (Republic of Kenya, 2005).

A recent analysis of the current performance levels revealed that the Ministry does not have baseline performance information aligned to its key outputs. A Service Delivery Survey carried out in 2003 was not focused on the key outputs but rather on the following aspects: speed, attitude of staff, integrity, probity and political impartiality, honesty, quality of staff facilities, selection on merit, courtesy, discipline, professionalism and responsiveness. The survey report indicated that the ministry's performance is not satisfactory. Whilst there is limited information on performance, the Ministry recognized that it has not lived up to its expected role.

Empirical studies conducted in Kenya showed that corporate governance is linked to firm performance. In her study, Jebet (2001) documented the corporate governance structures in listed companies; Kitonga (2002) studied the need for corporate governance in Kenya; Mwangi (2002) surveyed the corporate governance practices in the insurance industry; and

Mwangi (2003) investigated the determinants of corporate governance practices. Two years later, Mululu (2005) revealed that board activity is related to a number of corporate governance variables such as the board size, the number of executive directors, number of shares held by the largest shareholder, the number of shares held by directors, the number of shares by unaffiliated block holders, and the ratio of non-executive to executive directors. A year later, Langat (2006) studied the effect of corporate governance practices on declining performance of the listed firms.

A study detailing the relationship between corporate governance and performance of local authorities has not been done. From the situational analysis conducted in 2003, the Ministry identified the following challenges that needed to be addressed during the five-year planning period 2004 – 2009. They include: increased demand for good governance and improved service delivery; poor image of the Ministry and Local Authorities; poor performance by Local Authorities (service delivery, financial management and political governance); and constraining legal and policy framework (Republic of Kenya, 2005). The aim of this research was to determine the relationship between financial performance of local authorities and their corporate governance characteristics. There being no other previous study done on the current subject (corporate governance of local authorities in Kenya), this study sought to introduce ways and means of incorporating good corporate governance practices in local authorities. The corporate governance practices studied included the frequency of meetings by the council, political composition of the full council, the role of internal audit, the role of the audit committees, the effect of managerial practices, and the size of the full council.

1.4. Objectives of the Study

The broad objective of the study was to determine the relationship between corporate governance and financial performance of local authorities.

1.5. Significance of the Study

Ministry of Local Government

The findings will assist the policy makers especially in the Ministry of Local Government in formulating appropriate regulations to guide the governance of local authorities in Kenya, including the composition and size of key governance committees within the councils' administrative frameworks.

The Government in General

The findings will also guide the Government in setting up a benchmark policy through which corporate governance in state-owned enterprises can be based on.

Management of Local Authorities

The findings will guide the management of local authorities in determining the appropriateness of various governance characteristics and how they relate to the financial performance of their respective municipalities. This would help in designing a governance framework that is able to optimize financial output for the councils.

Future Researchers and Academicians

The study will also be an important resource for academicians and future researchers who may wish to investigate the future performance of public enterprises in Kenya.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1. Introduction

The broad objective of this study was to determine the role of corporate governance on financial performance of local authorities. In light of this, this chapter reviews empirical studies on corporate governance and financial performance. According to Mugenda and Mugenda (2003), literature review involves the systematic identification, location and analysis of documents containing information related to the research problem being investigated. The rest of the chapter is organized as follows: section 2.2 reviews empirical literature on corporate governance in local authorities; section 2.3 covers a review on corporate governance and financial performance; and section 2.4 is the conclusion of the chapter.

2.2. Corporate Governance in Local Authorities

Good corporate governance is about honest and transparent dealings between owners and managers. The real issues involve responsibilities and to whom the owners and managers owe them. In state-owned enterprises (SOEs) such as the local authorities, there is inevitably confusion between the interests of the state, on one hand, and the interests of managers, workers, citizens and consumers, on the other. In private enterprises, the confusion is between responsibilities owed to shareholders (especially majority shareholders), and managers, customers, creditors, workers and suppliers. In privatized companies, the

confusion is worse still, with managers still acknowledging the influence of the state (Bati, 2005).

SOEs often develop bad habits: burdensome bureaucracy, confused objectives, directors owing responsibility to the state or a ministry or even to individuals within government or a political party. Good governance means the SOE cannot ignore the interest of consumers/citizens just as the private enterprise cannot ignore the interests of minority shareholders, suppliers, creditors and workers. SOEs are often monopolies and it is the consumer who suffers most from a poorly governed monopoly. For the SOE, therefore, good corporate governance should aim for honest dealings with consumers and transparent reporting to citizens. Ultimately, however, good corporate governance, whether in a SOE or a private enterprise will depend on trustworthy, ethical directors and managers.

The Government's relationship to local authorities is similar to the relationship between a holding company and its subsidiaries, features of which include: a strong interest in the financial performance of the authority; reporting and accountability arrangements that facilitate an appropriate oversight by the state; and remedial action by the state where the authority's strategic direction deviates from that preferred by the laid out state guidelines. The Good Governance Standard for Public Services builds on the Nolan principles for the conduct of individuals in public life by setting out six core principles that it says should underpin the governance arrangements of all bodies – a clear definition of the body's purpose and desired outcomes; well-defined functions and responsibilities; an appropriate corporate

culture; transparent decision-making; a strong governance team; and real accountability to stakeholders (Chartered Institute of Public Finance and Accountancy [CIPFA], 2007).

Good governance requires that risk management is embedded into the culture of the organization; with members and managers at all levels recognizing that risk management is part of their job. At the highest level, risk management must be closely aligned to the organization's strategic objectives, ensuring that there is a clear focus, at the top of the organization, on those significant risks that would prevent the organization achieving its key business objectives. Local Authorities should, therefore, be able to demonstrate that risk management has been embedded in its corporate business processes, including: strategic planning; financial planning; service delivery; policy making and review; project management; and performance management (CIPFA, 2007).

A study to explore community governance in Victorian local government by O'Toole (2003) found that 'Good governance' in local authorities mean a combination of corporate and new public management methods to develop a stronger relationship between the state and the people. Thus the councilors as a board of directors are responsible for overseeing and controlling management in ensuring that they follow a more commercial style of management. Local government bureaucracies should be transformed to meet the needs of a corporate enterprise including the development of corporate plans (Kloot, 2001; Tucker, 1997). Councillors are also expected to take on new roles as a board of directors where there would be a separation of 'steering' or setting the policy framework and 'rowing' or the provision of services (Newnham and Winston, 1997). In this process the local citizens

become customers whose relationship to their local government is redefined as that of shareholders in 'enterprise local government' (Williamson, 2002). As part of the accountability chain customer satisfaction surveys are carried out annually to ensure that the local government is delivering its services efficiently and well.

Under the previous public sector arrangements, administration was a hierarchical model, with its highly standardized public services and unrivalled state strength (Pierre and Peters, 2000). However the move to new public management (NPM) has meant the acceptance of corporate methods of governance or the ways that organizations ensure compliance and codified corporate behaviors, including accountability and probity (Rhodes, 1996). NPM produces what has been termed a contract state model that focuses on results not rules where 'corporate planning, objective-setting, program budgeting, and performance monitoring became the order of the day' (Alford, O'Neill, McGuire, Considine, Muetzelfeldt and Ernst, 1994). The outcome of these corporate practices in government introduces a new type of governance that often focuses more upon standardizing the behaviour of managers than service delivery (Yeatman, 1996).

In local government, the introduction of corporate styles of governance places councillors in a similar position to a company board of directors, 'determining policy, setting objectives and establishing the strategic direction of council' (Victoria Local Government Board, 1995). They are leaders of an organization with a multi-million dollar budget and a workforce of hundreds of people. Councillors report to both the state government and their local community as corporate board members (Kloot, 2001). The rate-payers are the equivalent to

shareholders in a company and they hold their councillors accountable through the election box.

In this sense the local citizens are governors in the passive sense in that through elections they give legitimacy to the decisions of councils (Goss, 2001). Corporate governance in local government is dependent upon representative style electoral processes. Councillors as members of the board of directors report to their constituents and are held accountable through the electoral process. As a representative body councillors govern on behalf of their electors. This can involve the placement of 'experts' in the political positions where they play the role of what Pitkin terms 'acting for' (Pitkin, 1967). It involves a notion of trusteeship where representatives are allowed to make decisions because they have the ability to do so. They also act as representatives in that the citizens authorize them to act on the basis of their stated policies at the election. This view of representation is called the 'mandate' where the elections decide who will be given the authority to deliberate and decide for others (Manin, Przeworski and Stokes, 1997). But councillors are also accountable to the public in that they can hold their representatives responsible for their actions at each election. For Pitkin where authorization frees the representative to act on their own initiative, accountability gives the representative new and special obligations (Pitkin, 1967).

Both types of representation fit well with corporate styles of governance as the councillors (or board of directors) derive their legitimacy from the electorate (or local shareholders). They are able to 'steer' the direction of the corporation using NPM methods to assure internal accountability for the services they offer. The council is then organized and run

efficiently like a local business. The assumption that re-organizing the structures will get the governance 'right' is countered by those who argue that governance is a dynamic process of social and political actors, and therefore the dynamics need to be addressed (Pierre and Peters, 2000). Governance is more than just the organizational structures of government and has more to do with the interactions between structures and actors than the structures themselves (Leach and Percy-Smith, 2001). Recently the role of the public sector has undergone major change, and partnership arrangements between the public and private sectors have been established on a broad scale (Sabel, 2001). There is now an argument that while government involves only the state, new governance encompasses both the state and civil society (Leach and Percy-Smith, 2001). Government with its hierarchy and authority is now involved in networks and partnerships with private and voluntary sectors.

2.3. Corporate Governance and Financial Performance

2.3.1. Frequency of Meetings

The findings from a study by Mululu (2005) established that boards increase the frequency of their meetings following poor performance and as consequence of such increase the performance of firms improve as captured by the increase in firm value giving support to Jensen (1993) and Vafeas (1999) that the role of boards becomes increasingly important during crises, when shareholders' interests are in visible danger. On the whole however, the association between meetings frequency and firm value remains unclear, and the linkage between board activity and monitoring difficult to establish.

One year later, Lang'at (2006) developed a regression model to test the hypothesis that there is a positive relationship between firm's financial performance of preceding year and frequency of board meetings. The value of the firm was proxied by the Tobin's Q or Book-to-Market ratios. The findings indicated that the test statistics obtained led to acceptance of the null hypothesis that there is a positive relationship between firm performance of preceding year and frequency of board meetings. Gathura (2007) further sought to determine the relationship between various components of corporate governance and performance of manufacturing firms listed in the NSE. The study had sought to determine the relationship between firm performance and frequency of board meetings in manufacturing firms listed in the NSE between 1996 and 2006. The findings revealed that there exists a perfect linear relationship between performance measures and the frequency of boards meetings; among other governance structures. This was achieved through a regression-based F-TEST on each of the four performance measures (Tobin's Q; Return on Equity; Return on Assets; and Price-to-earnings ratios) that were used.

Jensen (1993) had argued that boards of well-run companies should be relatively inactive and exhibit few conflicts. Frequently scheduled meetings generate opportunity costs in the form of management time consumed, and cash costs in the form of traveling allowances and fees for board members. Yet real benefits can be derived from such meetings as directors have the opportunity to confer, set strategy and monitor management. Vafeas (1999), for instance found that meeting frequency was influential in improving operating performance in a manner consistent with agency theory.

2.3.2. Political Dynamics Influencing Corporate Governance

The notion that political interference in enterprise decision-making is detrimental to corporate performance is well documented throughout the robust body of theoretical studies on corporate governance. It is frequently argued that by maintaining control over enterprise decision-making, politicians can use enterprises to pursue so-called higher national goals, (e.g., employment maximization, regional development, industrial policies – Shleifer, 1998). They may also seek to control enterprises to achieve their own political and personal goals (e.g., increasing their political support and power) [Boycko et al.1996; Shleifer and Vishny, 1998]. Their pursuit of such goals may result in shareholders' inability to maximize wealth and thus in less favorable corporate performance.

Most of the existing evidence for how political interference affects corporate performance comes from studies that document the poor performance of state-owned enterprises (SOEs) compared with the performance of non-state-owned enterprises (NSOEs). The logic here is that the corporate governance structure of SOEs is associated with a higher degree of political interference and that their poor performance thus supports the idea that political interference damages corporate performance (Shleifer and Vishny, 1994). Shirley and Walsh (2000) further established that poor performance of SOEs is attributable to agency problems.

Alchain (1965) argued that since SOEs' ownership is widely distributed, their owners tend not to monitor managers well, because a state owner stands to gain little from the improvement in his enterprise's performance that would result from alleviating the agency problems. SOEs' agency problems can also be attributed to the absence or ineffectiveness of

external disciplinary mechanisms including competition from other firms (Machlup, 1967), the possibility of hostile takeover (Yarrow, 1986), and the threat of bankruptcy (Kornai (1980). Without these external mechanisms of corporate control, SOE managers can rest assured that inefficiency will almost certainly not result in hostile takeover and bankruptcy that would cost them their job. As a result, SOE managers have little incentive to strive to improve the performance of their enterprises

According to Roe (2003), political forces account for the difference in choice of corporate governance models among advanced industrial countries. Corporate governance arrangements inside the firm, Roe argues, interact deeply with a nation's politics. Political forces - party systems, political institutions, political orientations of governments and coalitions, ideologies, and interest groups - are the primary determinants of the degree of shareholder diffusion and the relationships among managers, owners, workers, and other stakeholders of the firm. Whatever the formal specifications of corporate law, politics shapes daily the calculations made by all players.

A study on East Asian economies by Qian (2000) established that governments generally have a close relationship with business enterprises through formal or informal channels. A review of the case of China indicates that China's transition from a planned to a market economy could be viewed as a two-stage evolutionary process, where the first fifteen years between 1978 and 1993 constituted the first stage and the second stage began in 1994 (Qian, 1999). In the first stage, the reform essentially was carried out incrementally to improve incentives and to increase the scope of the market for resource allocation.

The dynamics of government and business relationships was quite different in the two stages of reform. In the first stage, the government became more, rather than less, involved in enterprises. The government (especially the local government) was directly involved in corporate governance through its ownership and control. Indeed, in the first fifteen years in the first stage, because market and legal institutions were underdeveloped, maintaining or even increasing government control in enterprises in China yielded certain advantages, albeit second best. The miracle was that in spite of (or because of) pervasive government ownership and control of enterprises, the Chinese economy grew strongly and outperformed other transition economies. However, in the second stage, building market-supporting institutions, including legal institutions, became the main focus of the reform. At the same time, the government's control in enterprises had become more and more costly, and the government started to retreat from its control over enterprises through privatization, corporatization, and securitization.

The two perspectives imply that government control of firms can be understood as a transitional institution during the process of economic development. The relationship between the government and business enterprises should be studied by considering the overall institutional environment at a particular development stage. In China, the level of economic development and institutional environment was quite different in the first and the second stage. Therefore, the relationship between government and corporate governance should be examined through the dynamic perspective, rather than the static angle (Qian, 2000).

The view of government (political) control in corporate governance as a transitional institution consists of three major arguments. First, based on the modern theory of firm and corporate governance and the empirical evidence in the past decades, economists generally agree that government ownership and control of firms does not have obvious advantages over private ownership and control under well-established market institutions and with reasonable assumptions about the government's behavior. On the other hand, government ownership and control of firms clearly have major disadvantages. The government is not only concerned with economic matters and it often has political objectives. In some sense, we don't want to have a government that has strong profit motives so that it can act when the private sector has no incentives to do so. Another major problem with the government concerns its commitment ability. A big difference between government and the private sector is its power: the more powerful the government is, the harder for it to make a credible commitment. Finally, even without the problems of objectives and commitment, there is still an overload problem. If the government is overwhelmed with too many things, its efficiency declines quickly beyond its "core competence" of public goods provision and regulation.

2.3.3. Role of Internal Audit in Corporate Governance

Internal auditing involves the utilization of a systematic methodology for analyzing business processes or organizational problems and recommending solutions. Professionals called internal auditors are employed by organizations to perform the internal auditing activity. The scope of internal auditing within an organization is broad and may involve internal control issues such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations. Internal auditing frequently involves measuring compliance with the entity's policies and procedures.

However, internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities (Institute of Internal Auditors [IIA], 2007).

Internal auditing activity as it relates to corporate governance is generally informal, accomplished primarily through participation in meetings and discussions with members of the Board of Directors. Corporate governance is a combination of processes and organizational structures implemented by the Board of Directors to inform, direct, manage, and monitor the organization's resources, strategies and policies towards the achievement of the organization's objectives (Zabihollah, 2002). Internal auditing is often considered one of the "four pillars" of corporate governance, the other pillars being the Board of Directors, management, and the external auditor (IAA, 2007). A primary focus area of internal auditing as it relates to corporate governance is helping the Audit Committee of the Board of Directors (or equivalent) perform its responsibilities effectively. This may include reporting critical internal control problems, informing the Committee privately on the capabilities of key managers, suggesting questions or topics for the Audit Committee's meeting agendas, and coordinating carefully with the external auditor and management to ensure the Committee receives effective information.

According to KPMG (2003), the key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibilities by delivering: a review of the organization's control culture, especially the "tone at the top"; an objective evaluation of the existing risk and internal control framework; systematic analysis of business processes and

associated controls; reviews of the existence and value of assets; a source of information on major frauds and irregularities; ad hoc reviews of other areas of concern, including unacceptable levels of risk; reviews of the compliance framework and specific compliance issues; reviews of operational and financial performance; recommendations for more effective and efficient use of resources; assessments of the accomplishment of corporate goals and objectives; and, provision of feedback on adherence to the organization's values and code of conduct/code of ethics.

As noted in 'The Local Authorities Inspection Manual' the term 'audit' is increasingly coming to be used in a generalized sense, to mean any form of scrutiny or review of systems, processes or outputs. However, in the sense in which it has more traditionally been used, audit is the process by which the annual accounts of public and private sector bodies are subject to external scrutiny to provide independent assurance that they have been prepared in accordance with relevant legal and professional standards and give a 'true and fair' view of the financial performance and financial position of the audited body. However, it is one of the basic principles of audit in the public sector, as set out in the Public Audit Forum's publication 'The principles of public audit', that the scope of the audit should be understood to go beyond giving assurance on the accounts, to include examination of aspects of corporate governance and the use of resources - commonly described as 'value for money' (Republic of Kenya, 2008b).

In Kenya, financial audit covers the audit of the accounts and the underlying financial systems and processes (including, in specific parts of the public sector, whether public

money was spent for the purposes for which it was intended) and the financial aspects of corporate governance, such as internal control and risk management, and probity and propriety. Essentially, it provides assurance that public money has been safeguarded and accounted for properly. Performance audit is concerned with the value for money of services, functions, programmes or specific projects, and the systems and processes put in place by the body to manage its activity and use of resources and to prepare and publish performance information. In local government it also includes auditors' work in relation to best value performance plans (Republic of Kenya, 2008b).

The Ministry of Local Government in Kenya outlines the following as the main functions of internal auditing in local authorities: to review operations or programs to ascertain whether results are consistent with established goals and objectives and whether the operations or programs are managed according to plan; to review the management control system designed to ensure compliance with those policies, plans, procedures, laws, regulations, and contracts that could have a significant impact on operations. Also report whether the management control system is working as designed; to review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information; to review the means of safeguarding assets and, as appropriate, verify the existence of such assets; to appraise the economy and efficiency with which resources are employed; to isolate problem areas and provide a means for corrective action before the problem affects operational efficiency; and, to promote open communications and establish a positive relationship among the internal auditor, external auditor, agency staff, management, and audit committee and authority/board/committee/commission members as applicable.

2.3.4. Audit committees and corporate governance

According to local government Act cap 265 every local authority shall cause to be employed as head of internal audit an internal auditor who meets qualifications and requirements set out in the scheme of service applicable to local authority staff from time to time. The Act further stipulates that the internal auditor shall be reporting to the audit committee which shall review the internal auditor's comments findings and recommendations. Where as the CMA guidelines for listed companies directs that the board shall establish an audit committee of at least three independent and more executive directors the local governments Act directs that there shall be an audit committee whose chair shall be a councilor other than the finance chairperson. Other than the civic leaders members of the audit committee shall be the clerk and increases to council and the internal auditor who shall be the clerk and treasurer to council and the internal auditor who shall be the secretary to the audit committee (G.O.K) few Las have however implemented this requirement citing that the finance committee can adequately serve as an audit committee arrangements of Las but the practice has tremendous affect in both revenue generation and service delivery assets Mutemi (2006).

2.3.5. Size of council membership and financial performance

The size of the local authority is determined by the member of civil leaders sitting at the full council meeting in any civil authority just like the board size in the private sector, the size of the full council has significant relationship with financial performance. Mutemi (2006) found out that there is an adversely linear relationship between the council size (in terms of number of civic leaders) and service delivery of the same entity. Mutemi (2006) attributed this to several factors namely delayed decisions due to divided loyalties; myriad interests and limited resources; non willingness by council members to arrive at compromises; and

interference by outside political forces. However Bonn (2008) found no relationship between a council size, councilor's age and financial performance.

2.3.6 Management skills and experience and financial performance

The clerk to council and other chief officers in local authorities form the management according to local government Act Cap 265. The management is the link between the community and the civic leaders. The primary role of the management is to implement and evaluate council policies according to laid down procedures. In a legal sense the management is required to implement policies and ensure prompt feedback and not make them it is charged by law to act with due diligence.

From the situational analysis conducted in 2003 by the Ministry of Local government 80 percent of the management in all the 175 local authorities held those positions in acting capacity (Republic of Kenya 2005). Chief among other reasons for remaining in acting capacity is lack of both academic and professional qualifications coupled with a rather rigid collective bargaining agreement (GOK, 2005). The 2003 situational analysis also established the LA's which embrace ICT in their operations had better record keeping system and hence attracted more funds from development partners and the central government.

2.4. Corporate Governance in Kenya

Consultative Corporate Sector seminars held in November 1998 and March 1999 resolved that a Private Sector Initiative for Corporate Governance be established to: formulate and develop a code of best practice for corporate governance in Kenya; explore ways and means of facilitating the establishment of a national apex body (the National Corporate Sector

Foundation) to promote corporate governance in Kenya; and co-ordinate developments in corporate governance in Kenya with other initiatives in East Africa, the Commonwealth and globally (Private Sector Corporate Governance Trust, 2002).

On October 8, 1999 the Corporate Sector at a seminar organized by the Private Sector Initiative for Corporate Governance formally adopted a national code of the best practice for Corporate Governance to guide corporate governance in Kenya, and mandated the Private Sector Initiative to establish the Corporate Sector Foundation, and collaborate with the Global Corporate Governance Forum, the Commonwealth Association for Corporate Governance, the African Capital Markets Forum, Uganda and Tanzania in promoting good corporate governance (Private Sector Corporate Governance Trust, 2002).

The Kenya governance framework has faced a number of challenges in economic development. Most of these challenges relate to inefficient socio-economic and resources. The public sector reform programme begun in 1993, and has been addressing some of these challenges. The reforms aim at enhancing quality and efficiency in service delivery in civil service. The reform programme has three phases, which include cost containment performance improvement through rationalization of structures and functions and refinement. Consolidation and sustenance of reform gains. Phase of the reforms which focused on cost containment was not integrated with the budget process and did not reduce the Government wage bill. By 1999, the government had developed a comprehensive and integrated second phase public sector reform programme focusing on performance improvement with priority on rationalization of ministerial functions and structures, and staff rationalization and

management of the wage bill. This phase focused on making the Public Service leaner, more focused and better equipped with capability and capacity (Republic of Kenya, 2005).

The performance improvement initiative has introduced Result Based Management (RBM), undertaking service delivery surveys, developing services delivery benchmarks and service charters. Successful implementation of RBM require clear vision and mission, changes in management styles, strategic planning for change, a well- motivated and flexible workforce and a re-assertion of public service ethos. The RBM is expected to shape organization and work activities for the achievement of predetermined outputs/results. It is also expected to reorient the goals and objectives of the workforce towards cost effectiveness and responsiveness to customer demands and needs (Republic of Kenya. 2005). The Public Service Reform and Development Secretariat in the Office of the President, has been spearheading the reform initiative.

The Kenyan Local Authorities (LAs) are corporate entities that are established under the Local Government Act Chapter 265. In addition to the Act the LAs draw their legal powers from the Constitution of Kenya, other Acts of Parliament Ministerial Orders and By-Laws currently there are 175 LAS in Kenya. They include the City Councils, Municipals Councils, Town Councils, and County Councils with Ministry of Local Government as the overall entity to oversee their operations.

While these legal bodies constitute Local Government in Kenya, the local governance framework in Kenya is broader than the LAs. It consists of provincial district, location and

sub-location administration with technical staff drawn from various ministries. Inherent in the gamut of Local Government and local governance system are various public and private institutions, including civil society organizations. Kenya has no decentralization policy that rationalizes power sharing, responsibilities, and resources between the central government ministries, parastatals, District Development Committees, LAs and the private sector. This has been a problem at an operation level, the most of the institutions and organizations lacking synergy. Although the position of LAs remains uncertain if the District is adopted as the level of devolution after the review of the current constitution. The LAs have an advantage since they already have a participatory electoral framework in place.

LAs in Kenya are charged with the provision and management of infrastructure and services in their respective jurisdictions. Most LAs in Kenya face a number of challenges in realizing their mandate. The challenges include improvement of infrastructure and delivery of services, financial management, institutional and legal framework, human resource capacity, and managing rapid growth (Republic of Kenya, 1999). These challenges have resulted in poor service provision and management and many analysts have criticized the LAs, and questioned their role in local development. It is the efficiency of LAs that justified a reexamination of their role and the launching of the Local Government Reform Programme which also include the decentralization of service of provision and management (Mitullah and Waema, 2005)

2.5. Chapter Summary

The review indicates that good corporate governance combines the ‘hard’ factors – robust systems and processes – with the ‘softer’ characteristics of effective leadership and high

standards of behaviour. It incorporates both strong internal characteristics and the ability to scan and work effectively in the external environment. The internal combination of 'hard' and 'soft' characteristics involves: leadership, culture, accountability through systems and processes, and external focus on the needs of service users and the public. Even though many empirical studies have found a negative relationship between state ownership and corporate performance, this is at best only indirect evidence that a negative relationship exists between political interference and the corporate performance. Empirical studies in Kenya (Jebet, 2001; Kitonga, 2002; Mwangi, 2002; Mwangi, 2003; Mululu, 2005; Langat, 2006; and Gathura, 2007) have focused on corporate governance and financial performance of firms drawn from the private sector. To fill the existing knowledge gaps, this study sought to establish the relationship between corporate governance characteristics and financial performance of institutions drawn from the public sector, specifically, the local authorities in Kenya.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1. Introduction

Kothari (2003) asserts that the purpose of the research methodology is to give details regarding procedures used in conducting the study. It includes all techniques, methods and procedures adopted in the research. This chapter presents the research methodology. Section 3.2 and 3.3 describe the population and data & sample respectively while section 3.4 describes the sampling design, section 3.5 outlines the data collection tools and procedure, section 3.6 provides the research models and hypotheses, and section 3.7 outlines the model's diagnostic tests..

3.2. The Research Design

The study applied a causal-comparative research design. This is a design that attempts to determine reasons or causes for an existing condition in groups or individuals- in this case the financial performance of local authorities in Kenya in relation to their corporate governance structures.

3.3 The Population

As at December 2007, Kenya had 175 local authorities operating as per the guidelines stipulated under the Local Government Act (Cap 265) of the laws of Kenya (Republic of Kenya, 2008).

3.4 Sample Design and Sample Size

The study applied a mix of sampling techniques at each stage. In the first stage of sampling, the selection of local authorities to be studied was done through convenience sampling techniques. The sample thus comprised of 30 local authorities adjacent to the greater Nairobi region (See Appendix). They include Mavoko municipality, Olekejuado county, Thika municipality, Kikuyu town Council, Limuru municipality, Kiambu municipality, Ruiru municipality, Nairobi City Council, Machakos Municipality, Masaku county, Matuu town, Naivasha municipal, Nakuru municipal, Nakuru county, Kiambu county, Makueni county, Wote town Council, Kajiado town, Muranga county council and Thika county council. The reason for selection of these local authorities is two fold. First, is due to their proximity to the capital city: and secondly is due to the robust nature of business they handle on a daily basis as compared to upcountry country councils. The second stage involved selection of internal auditors who informed on the effect of the internal audit, audit committee, management, and size functions towards financial performance of local authorities. One auditor was drawn from each of the 30 local authorities above through simple random sampling. This ensured that there was no bias in selection of respondents. The study therefore had a sample size of 30 respondents drawn from the internal audit departments.

3.5. Data Collection

The data set comprised of both secondary and primary data. Secondary data was obtained from the offices of town clerks as well as the audited financial statements of the respective local authorities. The study sampled observations for the five-year period between 2002 and 2007. A structured data sheet (See Appendix III) was used to collect secondary data. On the

other hand, primary data on the role of internal audit, audit committee, management and size of board on financial performance of local authorities was obtained through a written questionnaire which was completed by selected internal auditors of the selected councils. The auditors were targeted as the respondents because they are conversant with financial issues affecting their respective councils. The questionnaire contained closed questions, structured on a 5-point Likert scale. An index on the 'internal audit', audit committee, management, and size variables was developed based on the responses from the Likert scale (See Appendix II).

3.6. Research Model

3.6.1. Conceptual Model

The study model is based on two major components namely corporate governance and financial performance of local authorities. The study conceptualized that financial performance of local authorities is a function of a mix of corporate governance variables. Equation (1) below presents the conceptual model for this relationship.

$$fPERF = f(Meeting, audit, political, auditcommittee, management, size) \dots \dots \dots (1)$$

Where:

- fPERF* = Financial performance
- MEETING* = Frequency of Meetings
- POLITICAL* = Political composition ratio of the finance committee
- AUDIT* = Role of the internal audit
- AUDIT COMMITTEE* = Role of the audit committee
- MANAGEMENT* = Role of management
- SIZE* = Effect of full council size

3.6.2. The Analytical Model

A multiple regression model of financial performance versus corporate governance characteristics was applied to examine the relationship between the variables. The model treats financial performance of the local authority as the dependent variable while the independent variables are frequency of meetings, political composition ratio of the full council, the role of the internal audit, the role of the audit committee, the role of the management, and the size of the full council. Equation (2) presents the algebraic expression of the analytical model applied.

$$(fPERF)_{it} = \beta_0 + \beta_1(Meeting)_{it} + \beta_2(Political)_{it} + \beta_3(Audit)_{it} + \beta_4(AuditCommittee)_{it} + \beta_5(Management)_{it} + \beta_6(Size)_{it} + \varepsilon_{it} \dots \dots \dots (2)$$

Where *i* indexes individual local authorities and *t* indexes financial years (*t* = 1, 2, 3, 4, 5). The dependent variable is financial performance (*fPERF_{it}*) by the *ith* authority on the *tth* financial year, while the independent variables are frequency of meetings (*Meeting*), Political composition of the full council (*Political*), role of internal audit (*Audit*) role of management (*management*), role of audit committee (*audit committee*) and size (*size*), ε_{it} is the error term.

Financial performance of local authorities was measured by the growth in revenue multiplied by capital ratio plus surplus expressed as a function of the revenue or minus deficit expressed as a function of revenue over the five-year period 2002-2007. Capital ratio is the amount spent on capital projects expressed as a function of the total expenditure. Frequency of board meetings was measured by the number of sittings held by the finance committee in a particular local authority within a given financial year. The political composition of the finance committee was measured by taking the ratio of councillors affiliated to the government friendly-party to those inclined to the opposition. Size was measured by number

of councillors sitting in full the council. Finally, the role of internal audit, audit committee, management and size of the board was measured by computing an 'AUDIT', 'AUDIT COMMITTEE', 'MANAGEMENT' AND 'SIZE' indices based on the responses derived from the Likert-scaled questions.

3.6.3 The Study Hypotheses

Using the model of equation (2), the study tested the following hypothesis.

H_0 There is no relationship between local authorities' financial performance and corporate governance practices.

H_1 : There is a relationship between local authorities' financial performance and corporate governance practices.

3.7. Diagnostic Tests

3.7.1. F- Test

In order to test the overall significance of the regression model, F-test was used to estimate if all the individual coefficients together were statistically different from zero at the 95% and 99% significance levels.

3.7.2. T-Test

To establish the significance of individual variables in each of the models, T-test was applied at both 95% and 99% levels of confidence. T-test was therefore applied in determining whether to accept or reject the above hypotheses.

3.7.3 Test of Serial Correlation

The Durbin-Watson statistics was used to detect the presence of autocorrelation in the residuals from a regression analysis of equation (2).

3.7.4 Test for Multi-collinearity

To test for multi-collinearity, equation (2) was regressed and thereafter, each of the explanatory variables was regressed against the other two in order to determine the high variance inflation factors (VIFs). Higher VIFs means more severe multi-collinearity. The Rule of thumb is that VIF values greater than 5 indicate severe multicollinearity. In some cases TOL (tolerance) statistic is used. It is computed by taking a reciprocal of VIFs.

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CHAPTER FOUR

4.0. DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.1. Introduction

This chapter presents the findings of the study, analysis of data and presentation of findings. For the purpose of showing the relationship amongst various variables, descriptive statistics such as frequencies and percentages have been used. The study applied secondary data that was collected from 30 local authorities comprising of the City Council of Nairobi, Municipal Councils, Town Councils, and County Councils. The data formed the basis for the analysis presented in this chapter. The chapter is organized as follows: Section 4.2 presents time series properties of the data used; and Section 4.3 presents analytical modelling of the relationship between various corporate governance practices and financial performance of local authorities.

4.2. Descriptive Properties of Independent Variables

The model of Equation (2) comprised of one dependent variable (financial performance) and five independent variables namely frequency of meetings, Political composition of the full council, role of internal audit, effect of the management, role of the audit committee and size of the full council. Financial performance index was computed as a sum of the product of the revenue growth rate and the capital ratio plus (or minus) the surplus or deficit expressed as a percentage of the annual revenue. The sections below provide some of the descriptive properties of the variables.

4.2.1. Revenue Productivity

Table 4.1 presents findings regarding the various level of revenue productivity within the sample local authorities over the sample period. The findings indicate that a cumulative majority of the councils were collecting revenues below Kshs. 100 Million in a year. Specifically, 83.3% in financial year (FY) 2002/2003; 73.4% in FY 2003/2004; 86.7% in FY 2004/2005; 73.3% in FY 2005/2006; and 53.3% in FY 2006/2007.

Table 4.1: Revenue Productivity 2002/2003 to 2006/2007 financial years

Financial Year	Revenue Productivity Range		
	Category	n	%
2002/2003	Below 50 Million	13	43.3%
	Between 50 - 100 Million	12	40.0%
	Between 100 - 500 Million	4	13.3%
	Above 500 Million	1	3.3%
	N	30	100.0%
2003/2004	Below 50 Million	11	36.7%
	Between 50 - 100 Million	11	36.7%
	Between 100 - 500 Million	7	23.3%
	Above 500 Million	1	3.3%
	N	30	100.0%
2004/2005	Below 50 Million	14	46.7%
	Between 50 - 100 Million	12	40.0%
	Between 100 - 500 Million	3	10.0%
	Above 500 Million	1	3.3%
	N	30	100.0%
2005/2006	Below 50 Million	10	33.3%
	Between 50 - 100 Million	12	40.0%
	Between 100 - 500 Million	6	20.0%
	Above 500 Million	2	6.7%
	N	30	100.0%
2006/2007	Below 50 Million	6	20.0%
	Between 50 - 100 Million	10	33.3%
	Between 100 - 500 Million	12	40.0%
	Above 500 Million	2	6.7%
	N	30	100.0%

Source: Field Data (2008)

4.2.2. Extent of Political Influence from the Government

Extent of political influence from the government was measured by the proportion of government-friendly councillors to that of the full council. Table 4.2 below presents the findings derived from the sample over the study period 2002/2003 to 2006/2007. The findings indicate that the extent of government's influence was minimal over the sample period. Specifically, 80% of the councils had less than 50% influence over FY 2002/2003; 86.7% of the councils had less than 50% influence over FY 2003/2004; 93.3% of the councils had less than 50% influence over FY 2004/2005; 96.7% of the councils had less than 50% influence over FY 2005/2006; and same for FY 2006/2007.

Table 4.2: Extent of Political Influence from the Government

Year	Proportion	Proportion of Government friendly councillors	
		n	%
2002/2003	Below 25%	11	36.7%
	26 - 50 %	13	43.3%
	51 - 75 %	6	20.0%
	N	30	100.0%
Proportion		n	%
2003/2004	Below 25%	11	36.7%
	26 - 50 %	15	50.0%
	51 - 75 %	4	13.3%
	N	30	100.0%
Proportion		n	%
2004/2005	Below 25%	15	50.0%
	26 - 50 %	13	43.3%
	51 - 75 %	2	6.7%
	N	30	100.0%
Proportion		n	%
2005/2006	Below 25%	21	70.0%
	26 - 50 %	8	26.7%
	51 - 75 %	1	3.3%
	N	30	100.0%
Proportion		n	%
2006/2007	Below 25%	23	76.7%
	26 - 50 %	6	20.0%
	51 - 75 %	1	3.3%
	N	30	100.0%

Source: Field Data (2008)

4.2.3. Perceived Role of Internal Audit in Financial Performance

Table 4.3 presents a distribution of responses regarding the extent to which the heads of internal audit agreed (or disagreed) to various aspects on internal audit in regard to financial performance of their councils. The findings indicate that a majority of the sample respondents (86.7%) agreed that the councils appoint to their management, auditors with a balanced mix of proficient individuals who are able to add value and bring independent judgment to bear in the decision making processes. A majority of the respondents (82.2%) also agreed that the councils exercises regular review of systems, processes and procedures to ensure the effectiveness of internal systems of control so that decision-making capability and the accuracy of reporting and financial results are always maintained at the highest level.

Other dominant aspects that featured include the following: the councils have competent personnel to advice in management of various risks (100%); the council has effective internal audit functions that have the respect and co-operation of both the board and management (60.0%); the heads of internal audit report administratively to the town clerk, and have ready and regular access to the chairperson of the council and the chairperson of the audit committee. (100%); and the audit committee of the council has written terms of reference that deal adequately with its membership, authority and duties. The findings of Table 4.3 indicate two weaknesses of internal audit emerge. First, the councils fail to conduct regular assessment of their performance (including the conduct of the town clerk, the mayor and the chairman). Secondly, internal audit functions are poorly coordinated with other internal and external providers of assurance to ensure proper coverage of financial, operational and compliance controls.

Table 4.3: Perceived Roles and Aspects of Internal Audit on financial performance

	Strongly agree		Agree		Not sure		Disagree		Strongly disagree	
	n	%	n	%	n	%	n	%	n	%
The council appoints to its management, auditors with a balanced mix of proficient individuals who are able to add value and bring independent judgment to bear in the decision making process (N=30)	22	73.4	4	13.3	-	-	3	10.0	1	3.3
The council exercises regular review of systems, processes and procedures to ensure the effectiveness of internal systems of control so that decision-making capability and the accuracy of reporting and financial results are always maintained at the highest level. (N=28)	18	64.3	5	17.9	2	7.1	2	7.1	1	3.6
The council conducts regular assessment of its performance (including the conduct of the town clerk, the mayor and the chairman). (N=30)	2	6.7	4	13.3	3	10.0	10	33.3	11	36.7
The council has competent personnel to advise in management of various risks (N=26)	22	84.6	4	15.4	-	-	-	-	-	-
The council has effective internal audit functions that have the respect and co-operation of both the board and management (N=30)	12	40.0	6	20.0	3	10.0	6	20.0	3	10.0
In line with the Institute of Internal Auditors code of practice, the heads of internal audit report administratively to the town clerk, and have ready and regular access to the chairperson of the council and the chairperson of the audit committee. (N=30)	26	86.7	4	13.3	-	-	-	-	-	-
Internal audit function in your council is coordinated with other internal and external providers of assurance to ensure proper coverage of financial, operational and compliance controls (N=30)	4	13.3	3	10.0	2	6.7	6	20.0	15	50.0
The audit committee of the council has written terms of reference that deal adequately with its membership, authority and duties. (N=30)	16	53.3	8	26.7	1	3.3	3	10.0	2	6.7

Source: Field Data (2008)

4.2.4. Perceived Role of Audit Committees in Financial Performance

Table 4.4 presents a distribution of responses regarding the extent to which the heads of internal audit agreed (or disagreed) to various aspects on internal audit in regard to financial performance of their councils. The findings indicate that all of the sample respondents were in agreement that: members of the audit committee are informed, vigilant and effective overseers of the financial reporting process and internal controls of the councils; the elections for the chair of the audit committee are done in accordance to local government Act; all heads of department are members of the audit committee and are invited to each audit committee meeting; external auditors reports and reports of inspectors from the Ministry are tabled in audit committees and queries raised discussed.

-However, from the findings presented in Table 4.4, four weaknesses of the audit committees emerge. First, a majority of the respondents (67.9%) disagreed to the fact that audit committees meet often enough to adequately discuss matters raised by the internal auditors. This indicates that audit committees do not meet as regularly as expected. Secondly, 83.3% of the sample respondents disagreed to the fact that the audit committees have adequate resources and authority to discharge their responsibilities. This indicates that the councils lack adequate resources to enable the audit committees to execute their mandate. Thirdly, it is evident that the audit committees lack independence to deal with issues raised by the internal auditors conclusively and professionally. Finally, a majority of the sample respondents (80.0%) disagreed to the fact that civic leaders appointed by the clerk to be the members of the audit committee are conversant with local authority financial management practices. This indicates that audit committees are in some cases composed of incompetent membership.

Table 4.4: Perceived Role and Aspects of Audit Committees in regard to Financial Performance

	Strongly agree		Agree		Not sure		Disagree		Strongly disagree	
	n	%	n	%	n	%	n	%	n	%
The audit committee meets often enough to discuss matters raised by the internal auditor adequately (N=28)	6	21.4	3	10.7	-	-	12	42.9	7	25.0
Members of the audit committee are informed, vigilant and effective overseers of the financial reporting process and the councils internal control (N=30)	14	46.7	16	53.3	-	-	-	-	-	-
The audit committee has adequate resources and authority to discharge its responsibilities (N=24)	2	8.3	1	4.2	1	4.2	6	25.0	14	58.3
The audit committee is independent and deals with issues raised by the internal auditor conclusively and professionally (N=30)	4	13.3	3	10.0	2	6.7	14	46.7	7	23.3
The elections for the chair of the audit committee are done in accordance to local government Act (N=27)	18	66.7	9	33.3	-	-	-	-	-	-
All heads of department are members of the audit committee and are invited to each audit committee meeting (N=30)	22	73.3	8	26.7	-	-	-	-	-	-
External auditors reports and reports of inspectors from the Ministry are tabled in audit committees and queries raised discussed (N=26)	21	80.8	5	19.2	-	-	-	-	-	-
Civic leaders selected by the clerk to be the members of the audit committee are conversant with local authority financial management practices (N=30)	2	6.7	3	10.0	1	3.3	6	20.0	18	60.0

Source: Field Data (2008)

4.2.5. Perceived Role of the Council Management in Financial Performance

Table 4.5 presents the distribution of responses regarding the extent to which the heads of internal audit agreed (or disagreed) to various aspects on the role of the top management in regard to financial performance of their councils. The findings indicate that a majority of the

sample respondents were in agreement to the facts that: chief officers frequently attend refresher courses to keep embraced with new developments (80.0%); chief officers possess the requisite skills to execute their respective functions (100.0%); top managements of local authorities adopt consultative approaches to decision making (71.4%); and that the management table in the relevant committees any issues which have financial implications (100.0%).

Table 4.5: Perceived Role of the Management in regard to Financial Performance

	Strongly agree		Agree		Not sure		Disagree		Strongly disagree	
	n	%	n	%	n	%	n	%	n	%
The chief officers are proficient with ICT matters and embrace ICT in operations (N=30)	4	13.3	2	6.7	3	10.0	14	46.7	7	23.3
Chief Officers frequently attend refresher courses to keep embraced with new developments (N=30)	6	20.0	18	60.0	-	-	6	20.0	-	-
The council regularly conducts Training needs assessments and implements its recommendations. (N=30)	3	10.0	2	6.7	2	6.7	13	43.3	10	33.3
The council sets aside enough time and resources to appraise performance of its budget (N=30)	-	-	4	13.3	-	-	12	40.0	14	46.7
Chief officers possess the requisite skills to execute their respective functions (N=26)	16	61.5	10	38.5	-	-	-	-	-	-
Management adopts a consultative approach to decision making (N=28)	8	28.6	12	42.8	-	-	5	17.9	3	10.7
Management tables in the relevant committees any issues which have financial implications. (N=30)	16	53.3	14	46.7	-	-	-	-	-	-
Management turnover and staff transfers have been minimal. (N=26)	3	11.5	2	7.7	2	7.7	13	50.0	6	23.1

Source: Field Data (2008)

From the findings presented in Table 4.5 above, the following issues emerge in regard to top managements' practices and their effects towards financial performance of the councils. First, the chief officers lack proficiency with ICT matters and fail to embrace ICT in operations (according to 70% of the respondents). Secondly, the top managements of councils fail to regularly conduct training needs assessments or implement recommendations arising from such assessments (according to 76.6% of the respondents). Thirdly, the top managements of the councils fail to set aside enough time and resources to appraise performance of their budgets (according to 86.7% of the sample). Finally, it is evident that there is high management turnover and staff transfers within the top management of the councils, as reported by 73.1% of the sample respondents.

4.3. Corporate Governance Practices and Financial Performance

The model of Equation (2) was subjected to linear regression in order to determine the nature of relationship between the independent and the dependent variables. The findings are presented in Table 4.6 below. The model was first subjected to F-TEST to determine if there existed a linear relationship between the dependent and the independent variables (i.e. if the model was significant). The findings indicate that the model was found to be significant at 95% level of confidence ($F_{(6, 23)} = 3.400; p < 0.05$). Secondly, the variables were subjected to collinearity tests. The Durbin-Watson Statistic indicate that there was no serial correlation present ($D = 1.951, P < 0.05$). The VIFs were significantly low ($VIFs < 5.0$) for each of the independent variables thus implying that the regression model free from multi-collinearity effects.

Table 4.6: Linking Financial Performance to Corporate Governance Practices

$$(fPERF)_{it} = \beta_0 + \beta_1(Meeting)_{it} + \beta_2(Political)_{it} + \beta_3(Audit)_{it} + \beta_4(AuditCommittee)_{it} + \beta_5(Management)_{it} + \beta_6(Size)_{it} + \varepsilon_{it}$$

Independent Variable	Regression Coefficients	t-Statistics	P-values	Collinearity Statistics	
				Tolerance	VIF
Constant	$\beta_0 = 0.167$ (0.262)	0.636	0.531	-	-
Frequency of meetings	$\beta_1 = -0.036$ (0.064)	-0.560	0.581	0.501	1.996
Proportion of Government friendly councillors to that of full council	$\beta_2 = 0.003$ (0.002)	1.935*	0.035	0.931	1.074
Role of internal audit	$\beta_3 = 0.084$ (0.036)	2.325*	0.029	0.671	1.489
Role of the audit committees	$\beta_4 = 0.028$ (0.035)	0.792	0.436	0.474	2.111
Effects of the Management	$\beta_5 = -0.091$ (0.035)	-2.600*	0.016	0.557	1.795
Size of Full Council	$\beta_6 = -0.001$ (0.002)	-0.440	0.664	0.417	2.401

Dependent variable = Financial Performance

* Denotes significance at 5% level (P-values less than 0.05)

Values in brackets are standard errors for coefficients

R² for the model = 0.67; Test Statistics for model's significance is $F_{(6, 23)} = 3.400$ (P < 0.05)

Durbin Watson Statistic for serial correlation = 1.951 (P < 0.05)

The findings of Table 4.6 above indicate that only three of the six independent variables were found to be significant at 95% level of confidence. They include: Political composition of the full council; the role of internal audit; and managerial practices by the top management of the councils. This indicates that the extent of financial performance by the local authorities is influenced by their political composition, the manner in which internal audits are conducted, and managerial approaches applied by the chief officers.

CHAPTER FIVE

5.0. DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1. Introduction

This chapter presents the discussion of findings, conclusions and recommendations derived from the findings of the study. The chapter also presents the limitations that were encountered in the process of gathering findings.

5.2. Discussion of Findings

The study was based on the null hypothesis that financial performance of local authorities in Kenya is influenced by a mix of factors related to their corporate governance practices. They included the frequency of meetings, Political composition of the full council, role of internal audit, effect of managerial practices, role of the audit committee, and size of the full council. Financial performance was considered as a function of revenue growth rate, the capital ratio, and revenue surplus or deficit expressed as a percentage of the annual revenue. The findings from the regression analysis established that financial performance by the local authorities is influenced by their political composition, the manner in which internal audits are conducted, and managerial approaches applied by the chief officers.

Earlier findings from descriptive analysis (Table 4.2) revealed that the extent of government's influence is minimal within the local authorities. Specifically, the findings established that the extent of government involvement was less than 50% in a majority of the local authorities. This lack of dominance by government-friendly councillors therefore has an

effect on council's revenue productivity. The findings presented in Table 4.6 indicate that the t-statistic aligned to the coefficient on "internal audit" has a positive sign. This implies a perfect linear relationship between internal audit practices and financial performance of local authorities. Findings derived from Table 4.3 indicated that the councils fail to conduct regular assessment of their performance (including the conduct of the town clerk, the mayor and the chairman), and internal audit functions are poorly coordinated with other internal and external providers of assurance to ensure proper coverage of financial, operational and compliance controls. This has resulted to a decline in revenue productivity in most of the councils over the years. Similarly, poor managerial practices by the chief officers of the councils have resulted to poor financial performance over the years. The study identified some of these practices as follows: lack of proficiency with ICT matters and failure to embrace ICT in operations; failure to regularly conduct training needs assessments or implement recommendations arising from such assessments; and failure to set aside enough time and resources to appraise performance of their budgets. In addition, most of the councils have also experienced high turnover and staff transfers within the top management. This also has an effect on their revenue productivity and hence financial performance.

The findings agree with previous empirical studies by Shirley and Walsh (2000), that poor performance of state-owned enterprises is attributable to agency problems. Agency relationship is a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. The citizens are the principals while the councils or the councillors are the agents. The study also agrees with the findings by Zabihollah (2002) that corporate governance is a combination of processes and

organizational structures implemented by the Board of Directors to inform, direct, manage, and monitor the organization's resources, strategies and policies towards the achievement of the organizations objectives. A failure of these processes has an effect on financial performance. Finally, the findings agree to assertions from the Institute of Internal Auditors (2007) that internal auditing is often considered one of the “four pillars” of corporate governance, the other pillars being the Board of Directors, management, and the external auditor. Failure to observe professional ethics by internal auditors has been found to have an implication on financial performance of local authorities.

5.3. Conclusions

The study therefore concludes that financial performance by the local authorities in Kenya is influenced by their political composition, the manner in which internal audits are conducted, and managerial approaches applied by the chief officers. This is further linked to failure by the councils to conduct regular assessment of their performance; poor coordination between the internal and external providers of assurance; and high staff turnover and transfers from within the top management of the councils. The findings have been found to concur to previous evidence from empirical studies on corporate governance.

5.4. Limitations of the Study

The study had focused on 30 local authorities that are adjacent to the Nairobi region. This was occasioned by lack of huge resources on the side of the researcher that would be required to cover the entire population of 175 local authorities in Kenya. The study was also limited to selected aspects of corporate governance namely frequency of meetings, Political composition of the full council, role of internal audit, effect of managerial practices, role of

the audit committee, and size of the full council. Given that financial performance of the councils could be attributable to other factors that were not covered in this study, then the findings of the study would not necessarily be generalizable to the entire population of local authorities in Kenya.

5.5. Recommendations

Further research is recommended to establish other factors related to corporate governance that influences financial performance of local authorities. Given that the study was limited to six variables stated above, further research can be conducted to incorporate other variables such as the number of council committees; the structure of council committees (proportion of the executive in relation to the entire committee size); the diversity factor (ethnic minority and gender diversity); and types of existing council committees.

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APPENDICES

Appendix I: Questionnaire Cover Letter

November 17, 2008

Dear respondent,

I am a postgraduate student at the University of Nairobi pursuing a Masters Degree in Business Administration. As part of partial fulfillment I am conducting a research on: “**THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF LOCAL AUTHORITIES IN KENYA**”. For this reason I would appreciate if you would kindly spare a few minutes of your time to fill in the blanks in the attached list of questions to the best of your knowledge as they apply to yourself or your business.

The information in this questionnaire will be treated with confidentiality and in no instance will your name be mentioned in this research. In addition, the information will not be used for any other purpose other than for this research. Your assistance in facilitating the same will be highly appreciated.

Thank you in advance.

Yours Faithfully

KIAMBA M. JIMMY
REG NO: D61/P/7095/05

SUPERVISOR

Appendix II: Questionnaire for Heads of Internal Audit

The purpose of the questionnaire is to evaluate the perceived role of internal audit in financial performance of local authorities. Please answer the questions by ticking in the boxes provided.

SECTION A: GENERAL INFORMATION

1. Name of the council (Optional) _____
2. Gender
 - a. Male
 - b. Female
3. How long have you worked in the audit department of your council _____ Years

SECTION B: INFORMATION ON INTERNAL AUDIT

In the questions below specify the extent to which you agree (or disagree) with various aspects of internal audit in regard to financial performance of your council

5 = strongly agree 4 = Agree 3 = Not Sure 2 = Disagree

1 = strongly disagree

4. The council appoints to its management, auditors with a balanced mix of proficient individuals who are able to add value and bring independent judgment to bear in the decision making process.

5 4 3 2 1

5. The council exercises regular review of systems, processes and procedures to ensure the effectiveness of internal systems of control so that decision-making capability and the accuracy of reporting and financial results are always maintained at the highest level.

5 4 3 2 1

6. The council conducts regular assessment of its performance (including the conduct of the town clerk, the mayor and the chairman).

5 4 3 2 1

7. The council has competent personnel to advise in management of various risks
 5 4 3 2 1
8. The council has effective internal audit functions that have the respect and co-operation of both the board and management
 5 4 3 2 1
9. In line with the Institute of Internal Auditors code of practice, the heads of internal audit report administratively to the town clerk, and have ready and regular access to the chairperson of the council and the chairperson of the audit committee.
 5 4 3 2 1
10. Internal audit function in your council is co-ordinated with other internal and external providers of assurance to ensure proper coverage of financial, operational and compliance controls
 5 4 3 2 1
11. The audit committee of the council has written terms of reference that deal adequately with its membership, authority and duties.
 5 4 3 2 1
12. In what other ways does internal audit affect the financial performance of your council?



SECTION C: INFORMATION ON AUDIT COMMITTEE

In the questions below specify the extent to which you agree (or disagree) with various aspects of audit committee in regard to financial performance of your council.

5 = strongly agree 4 = Agree 3 = Not Sure 2 = Disagree 1 = strongly disagree

13. The audit committee meets often enough to discuss matters raised by the internal auditor adequately.

5 4 3 2 1

14. Members of the audit committee are informed, vigilant and effective oversees of the financial reporting process and the councils internal control.

5 4 3 2 1

15. The audit committee has adequate resources and authority to discharge its responsibilities

5 4 3 2 1

16. The audit committee is independent and deals with issues raised by the internal auditor conclusively and professionally.

5 4 3 2 1

17. The electronics for the chair of the audit committee are done in accordance to local government Act.

5 4 3 2 1

18. All heads of department are members of the audit committee and are invited to each audit committee meeting.

5

19. External auditors reports and reports of inspectors from the Ministry are tabled in audit committees and queries raised discussed.

5 4 3 2 1

20. Civic leaders selected by the clerk to the members of the audit committee are conversant with local authority financial management practices

5 4 3 2 1

21. In what other ways does internal audit affect the financial performance of your council?

SECTION D INFORMATION ON MANAGEMENT (CHIEF OFFICERS)

In the questions below please specify the extent to which you agree with various aspects of management or chief officers of your council.

22. The chief officers are proficient with ICT matters and embrace ICT in operations

5 4 3 2 1

23. Chief Officers frequently attend refresher courses to keep embrace t with new developments

5 4 3 2 1

24. The council regularly conducts Training needs assessments and implements it recommendations.

5 4 3 2 1

25. The council sets aside enough time and resources to appraise performance. its budget

5 4 3 2 1

26. Chief officers possess the requisite skills to execute their respective functions

5 4 3 2 1

27. Management adopts a consultative approach to decision making.

5 4 3 2 1

28. Management tables in the relevant committees any issues which have financial implications.

5 4 3 2 1

29. Management turnover and staff transfers have been minimal.

5 4 3 2 1

29. In what other ways does management affect the financial performance of your council?

THANK YOU FOR YOUR RESPONSES

Appendix III: Data Sheet

Council	Year	NARCC councillors	Full Council	Revenue	Growth	Surplus	Capital ratio	Meetings	Internal Audit	Audit Committee	Management
1. NCC											
2. MAVOKO MC											
3. OLEKAJUADO CC											
4. THIKA MC											
5. KIKUYU TC											
6. LIMURU TC											
7. KIAMBU TC											
8. RUIRU TC											
9. KAJIADO TC											
10. MAKUENI CC											
11. WOTE TC											
12. MACHAKOS MC											
13. MASAKU CC											
14. THIKA CC											
15. MATUU TC											
16. MURANGA CC											
17. NAKURU MC											
18. NAIVASHA MC											
19. NAKURU CC											
20. MUTITO ANDEI CC											
21. EMBU CC											
22. KANGUNDO TC											
23. KERUGOYA KUTUS MC											
24. MURANGA MC											
25. MERU MC											
26. KITUI MC											
27. NYAMBENE CC											
28. NAROK CC											
29. MWINGI TC											
30. EMBU MC											