

**EFFECT OF FINANCIAL MANAGEMENT PRACTICES ON FINANCIAL  
PERFORMANCE OF COUNTY GOVERNMENTS IN KENYA**

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## DECLARATION

This research project report is my original work and has not been presented in any other university

Signed.....Date.....

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This research project report has been submitted with my approval as the university supervisor

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## **DEDICATION**

This research project is dedicated to the Almighty God in whom I live, move, and have my being. For the gift of family and friendships that span space and time and an inspiration to pursue my dreams. Finally, to Wanjiku Njuguna you are a special gift to my life.

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## **ABBREVIATIONS AND ACRONYMS**

|              |  |
|--------------|--|
| <b>CDF</b>   | Constituency Development Fund                      |
| <b>CG</b>    | County Government                                  |
| <b>CRA</b>   | Commission for Revenue Allocation                  |
| <b>IFMIS</b> | Integrated Financial Management Information System |
| <b>KENAO</b> | Kenya National Audit Office                        |
| <b>KNBS</b>  | Kenya National Bureau of Statistics                |
| <b>NPM</b>   | New Public Management                              |
| <b>OCOB</b>  | Office of the Controller of Budget                 |
| <b>PFMA</b>  | Public Financial Management Act                    |
| <b>VIF</b>   | Variance Inflation Factor                          |

## ABSTRACT

The purpose of the study was to determine the effect of financial management practices on financial performance of County Governments in Kenya. The study used cross sectional research design. The target population for the study was all the 47 County Governments in Kenya. The study used secondary data from County Government financial statements for the year 2015/2016 which was available from the website of the Office of Controller of Budget (OCOB). Population and size per county data was retrieved from the Kenya National Bureau of Statistics (KNBS) and Commission for Revenue Allocation (CRA) websites respectively. Statistical package for social sciences (SPSS) was used for inferential and descriptive statistics data analysis. The dependent variable was financial performance while the independent variables were budgeting, sources of revenue, allocation of financial resources and control of funds. Population per county and size per county were the control variables used in the study. The regression model accounted for 81.5% of financial performance of County Governments in Kenya as represented by the adjusted  $R^2$  which was 0.815, essentially means that financial management practices significantly affected financial performance of County Governments in Kenya. The intercept of this model was 0.187. Allocation of resources had the greatest strength on effect on financial performance, followed by control of funds as indicated by the standardized beta of 0.799 and 0.201 respectively. Size of the county and sources of revenue did not have a statistically significant effect on financial performance, since their significance was greater than 0.05. The diagnostics test was carried out for Multicollinearity, auto collinearity and Homogeneity. Durbin Watson statistics was used to test autocorrelation and the statistic was 2.703 which was between zero and four showing there was no auto collinearity. Multicollinearity was tested by Variance Inflation Factor(VIF), all variables had VIF values of less than 10 which shows there was no multicollinearity. Levene test was used to test Homogeneity, the test was not significant at  $\alpha=0.05$  a strong indication that there was no homogeneity which meant that the model could be relied on. The study recommends that Counties should strive to achieve their budgeted revenues since a decrease in actual revenues from the targeted revenue affects the overall financial performance of the counties. Counties should also look at the factors that affect missed revenue targets including creating diverse sources of revenues. Control of funds is also a key area that counties should undertake thoroughly and consistently since it has a significant impact on financial performance. Further counties should consistently strive to expense all their projected expenditures. There should also be a deliberate attempt to allocate more of the funds to development expenditure as opposed to recurrent expenditure. For the financial year 2015/2016 most of the county allocations were 70-90% on recurrent expenditures and prioritization of expenditures.



# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the Study

Financial management explains the impetus within the organization that determines the success of any business enterprises, whether public sector or private sector. Gitman (2007) defines financial management as a business management area, devoted to careful decision making in the use and identification of capital resources to achieve organizational objectives. Financial performance on the other hand is the measure of a firm's financial condition, over a specific period for comparison among firms with similar characteristics across the industries. The financial performance of organization is often measured through an analysis of financial statements (Ogilo, 2012).

This study was anchored on the principal-agency theory in conjunction with stewardship theory. The principal-agency theory defines the relationship between two parties the agent and the principal. Agency theory exists to identify and mitigate the problems that may arise because of divergence of goals pursued by the agents with respect to the expectations of the principal (Jensen & Meckling, 1976). The choice of this theory is important as it underscore the relevance of the existence of this relationship and how it helps in the development of financial management practices and financial performance. Stewardship theory was coined from the understanding that agents will not necessarily pursue their own interest at the expense of the principal, Donaldson and Davis (1991 & 1993). Stewardship theory assumes that these agents are stewards and will conduct the affairs of an organization in a manner that will maximize financial performance, as there exists organization structures.

The choice of this theory is relevant as it is used to predict the financial performance of the county government, the role that the devolved system of government is supposed to play and the structures to facilitate this role.

Kenya had a new constitution dispensation in 2010, that operationalized a devolved system of government and the decentralization of services, key among them fiscal devolution. The county governments are expected to have excellent financial management practices, provide superior value for money services and conduct the affairs of the county in strict adherence to the approved budgets (Ritonga, 2014). The Commission for Revenue allocation (CRA) is mandated to allocate the National Government funds to all the 47 counties in the Republic of Kenya and recommend on financial management matters. The revenue allocated per county is a function of the land area, county population, basis equal share parameter, the poverty gap and the fiscal responsibility of the county, CRA (2017) County governments are also supposed to internally generate their own revenues; the constitution also mandates National assembly, controller of budget (OCOB) and Kenya National Audit Office (KENAO) and to have an oversight role over the financial management and financial performance of counties (PFMA, 2012). It is on this context that the study tries to find the effect of Financial Management Practices to financial performance of County Governments in Kenya?

### **1.1.1 Financial Management Practices**

Financial management practices are roles performed by the accounting officer or other designated officer in the areas of financing decisions, investment decisions and capital budgeting. Financial management is a very important aspect in any organization be it private or public, (Shah, 2007).

Financial management is the identification, acquisition, allocation and utilization of assets financial resources with the organizational goal in mind (Van, Home & Wachowize, 2001). Financial management can be looked at from a descriptive, operational and analytical point of view. Descriptive involves financing decisions, investment decisions and capital budgeting. Operational involves financial management in the long run and in the short run. Lee, A.C., Lee, J.C. and Lee, C. (2009) postulated that two dissimilarities, a time horizon of more than one year for long-term financial management while short-term financial management with time horizon of less than a year includes managing current assets and current liabilities.

Ojo (2009) asserted that it is the role of the accounting officer or any other designated executive officer to manage the funds of the country government. It ensures that Funds are managed efficiently and that financial management deals with the efficient use of funds. It is a method of showing and ascertaining the financial position of government or business over a period. These practices include financial forecasting, budgeting, monitoring and internal control. He further postulates that if these activities are not performed properly and effectively the local governments will end up performing poorly.

### **1.1.2 Financial Performance of County Governments**

Financial performance is the degree of a firm's overall health over a specified duration. It underscores the role of a firm financial stability as to quality of services offered, reduced creditors turnover, enhanced throughput and financial risk management. Maphalla (2015) indicated that financial performance is measured using financial statement analysis. This analysis measures the revenue, operating income and profit after tax, financial position, cashflow, the level of financial leverage and the ability to meet financial commitments. In

the case of county government, the allocation from the National Government, the efficiency in collection of local revenue and the expenditure allocation of expenditure into development expenditure and recurrent expenditure.

Measurement of financial performance in county government is different from measurement of other business and sometimes poses a great challenge. This is because other factors tend to affect financial performance in county government like political influence, interested parties and bureaucracy which are difficult in measuring, due to their nature of being qualitative and subjective (Zakaria, 2014).

### **1.1.3 Financial Management Practices and Financial Performance of County Governments**

Theoretically, it is envisaged that there exists a significant relationship between financial management practices and financial performance (Dennis, 2004). The relationship between financial management practices and the financial performance in county government has been engaging task because other factors such as political interference, interested parties and bureaucracy affect their financial performance. Counties, municipalities and any other form of devolved system of government are segmented by their level of performance especially on the revenue collections and the absorption rate of recurrent expenditure compared to that of development expenditure (Carmeli, 2002). Muli (2016) in his study on the effect on financial management practices and budget implementation of Machakos County found that financial management practices had a significant relationship on the success of budget implementation of county government.



Maphalla (2015) did a study to ascertain the financial performance of South Africa local municipalities and deduced an existing relationship between the size of the municipality and the financial performance. There was also a substantial relationship between the reliance of revenue with financial performance of the organisation. Coggburn and Schneider (2001) in their study to analyze the relationship between the quality of management and the performance of budget for local government in the United States. They established a significant relationship between financial performance and financial management. Shah (2007) in his book about local public financial management indicated that public financial management is important to ensure the effective use of internal and external resources, in that way advancing this relationship. Dennis (2004) in her study concluded that there was a positive relationship between local government financial performance and financial management practices.

#### **1.1.4 County Governments in Kenya**

There are 47 County Governments in Kenya and one National government. The county governments were operationalized after the 2010 constitution came into effect. These counties are divided into county assemblies and county executives. Financial Management practices falls under the county treasurer, who is a member of the county executive (COK, 2010). At inception, the activities of the county treasurer had been on the increase due to funding been channeled to the county by the Central Government and other donors such as the World Bank. Nonetheless, many of the County Governments find it difficult to access funding because their financial management practices are still wanting.

The management needs to ensure finances of the organizations are properly managed (Wanjiru, 2008). Counties in Kenya are heterogeneous; they are different in size, in terms of revenue collection, population. The Commission for Revenue Allocation uses a formula in the allocations of resources from the central government to sort of create uniformity in County government allocations.

## **1.2 Research Problem**

Financial management remains the life blood of every organization and there is need to ensure effective and proper use of financial resources (Gitman, 2007). Yet it is also one of the major pitfalls of very many organizations if not properly implemented. County governments are still at their infancy level in Kenya and this has not shelved them from the challenges of poor financial performance. The OCOB has been giving annual reports of county government's performance based on financial statements since the inception of county governments.

Ngaruro (2013) in his study on the relationship between financial planning and financial performance of public service organization concluded that indeed there exist a positive relationship between financial planning and financial performance. He recommends further research should be done to evaluate the other variables that affect financial performance. Golda (2013) did a study on the effect of financial management practices to financial performance of the Kenya Medical Training College, the study used primary data and suggested that further research be done on a government related agency. Wangombe (2016) did a study to analyze the use of public funds effectively in the county government of Nakuru Kenya, this study also relied on primary data which is subjective

and qualitative in nature and subjective to some extent; this study will therefore measure the relationship of these variables based on quantitative data. There has been a rising wave of Public Management reforms giving rise to the concept New Public Management (NPM) leading to a surge of studies about local governments, however very little information that has been collected over time to explain why projects are unable to meet objectives for several local governments (Pilcher, 2011). This study therefore seeks to gather empirical evidence within the Kenyan jurisdiction. This study sought to answer the question; what is the effect of financial management practices on financial performance of the County Governments in Kenya?

### **1.3 Objective of the Study**

To determine the effect of financial management practices on financial performance of County Government in Kenya

### **1.4 Specific Objectives**

To determine the effect of budgeting on financial performance of County Government in Kenya

To determine the effect of allocation of financial resources on financial performance of County Government in Kenya

To determine the effect of sourcing of funds on financial performance of County Government in Kenya

To determine the effect of control of funds on financial performance of County Government in Kenya

## **1.5 Value of the Study**

This study is expected to build on the existing literature of financial management practices and financial performance. It is anticipated that the study will provide empirical evidence for agency theory and stewardship theory on the areas of financial management and how this affects financial performance. The study is also expected to provide a framework for financial management practices which may be used as a test base for further research.

The study will be useful to County Governments in fully implementing financial management practices and overcoming implementation challenges. The study will also benefit in integrating the best practices in financial management practices. By and large the study is projected to affect the overall improvement on financial performance. The outcomes are also expected to be used by other county governments which have homogenous characteristics.

This study will be very useful to the following oversight institutions of the county governments OCOB, KENAO, and CRA. It will assist in the operationalization of the existing Public Financial Management framework and requisite adjustments and improvements to these frameworks.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter systematically reviews related literature on effects of financial management practices to financial performance in the context of County Governments; the theories, concepts that apply.

### **2.2 Theoretical Review**

Theories are used to describe, forecast, and explain a concept. This study will be anchored on the following theories; Agency theory and Stewardship theory.

#### **2.2.1 Agency Theory**

Principal-Agency theory arises where one party, the agent, enters contractual agreement to act in place of the principal. The agent is often tempted to engage personal interest and strategies without reference to the principal (Jensen & Meckling, 1976). It theorizes that given a choice the agent will act in a manner that advances his interest and this behavior ends up conflicting with the principal's interest (Eisenhardt, 1989). Agency problem is birthed from the divergence of strategies as advanced by the principal and his agent. Agency problem and how to mitigate this problem is therefore the premise upon which agency theory is based.

County Governments in Kenya receive allocation from the National Government and oversee the management of county public funds by collecting locally generated revenues and incurring both recurrent and development expenditure. Therefore, county government are responsible in the control and management of public finance as agents while the OCOB act as the principal on behalf of the people of the republic Kenya. The KENAO

also audits the county government to ensure that the financial plans set out by both the OCOB and County governments are implemented (OCOB, 2016).

The choice of this theory is important as it underscores the role the county government plays as an agent and the OCOB as the principal. The agency problem foreseen, how this is being mitigated and its impact on financial performance of county governments. Its weakness is that the agents are guided by human motivation only, which entails uncertainty in the actions that they take based on what will motivate a certain individual.

### **2.2.2 Stewardship Theory**

Stewardship theory is a theory that brings a convergence between the agency theory assumptions that agents will act at the expense of the principal. Stewardship theory assumes that the managers behave in a trustworthy manner and focus on the betterment of the organization regardless of the manager's interest (Davis & Donaldson, 1997). Stewardship theory is anchored on the premise that there will be no opportunistic managers and believes that all actions that they will take will be in the best interest of the organization (Eisenhardt, 1989). The theory postulates that the agent and the principal relationship are based on choice and that the choice they will make is that which advances maximum organizations performance. Eddleston and Kellermanns (2007) found positive outcome on the firm's performance when both firms choose to work together.

The choice of this theory is important as it underscores the role that the county executives play as stewards of the county government funds; it assumes that all decisions that will be taken by the county will be to increase the firm's financial performance and provide value for money in all the county financial engagements (Monkam, 2014).

## **2.3 Determinants of Financial Management Practices**

Financial management practices are roles carried out by an authorized finance officer of a firm ranging from management of non-current assets, working capital, capital structure decisions, integrated financial management reporting systems, and financial reporting analysis (Lee et al., 2009). The broad scope of the definition of financial management is an indication that the practices vary from definition to definition and industry sector that is public or private. This study will however be centered on the following financial management practices allocation of financial resources, sourcing of funds, control of funds and financial planning.

### **2.3.1 Budgeting**

Budgeting is the organization of financial data with the aim of developing a strategic plan to properly manage revenue, expenditure, assets and liabilities to meet short term obligations (Diliberto, 2006). Budgeting is part of the organizational plan and it entails preparation of draft budgets and execution of the approved budgets (Gildenhuis, 1993). This entails the contrasting of financial performance against the budgeted.

The PFMA requires county government to only use funds as per budgets that have been approved by the OCOB. It is through financial planning that government revenue and expenditure performance is derived. The budget process entails preparation, approval, execution, monitoring and evaluation. These roles are often undertaken by distinct institutions that have varying degree of autonomy and interdependence (Adamolekun, 1983). Budgeting is a financial tool that is used to evaluate and control future activities of the organization, of importance is that audit and control should be the last stage since organizations may have the best budgets but may often end up.

### **2.3.2 Sources of Revenue**

Sources of revenue include Taxes, levies and other non-tax revenues, grants, aid and allocation from the central government. It's therefore the objective of any accounting officer to increase revenue and ensure autonomy since this is inherently within its control. Grants and allocation from the central government are external sources of revenue and therefore it's not within the mandate of the county to determine its allocations. County Governments in Kenya may borrow but only where the Treasury cabinet secretary (TCS) has been informed and requisite approval has been issued. Shreshta (1996) contended that financial resources provide smooth energy for local governments upon which their activities are stimulated. There are various sources of funds in the county hence; he concluded that there should be autonomy in financial management.

### **2.3.3 Financial Resources Allocation**

Financial resources entail the decisions of expenditure stream that the county government will be involved in. Bird, Freund & Wallich (1995) indicated that providing adequate services in local government is a mirage because of lack of adequate financial mechanism. The PFMA and OCOB have provided guidance on how resources should be allocated with an emphasis. Prudent allocation of financial resources therefore requires more resources be spent on development expenditure and less resources on recurrent expenditure. Expenditures should only be allocated to high priority projects and should only be on activities that the National government will not fund.



### **2.3.4 Control of Funds**

Control of funds is the oversight and efficient management over funds authorization such that funds are used only for the authorized purposes and that expenditures do not exceed the amounts authorized, USAID (2017). This is affected using budgets and it's the work of the accounting officer to ensure that he compares the approved budget against the actual performance. Control entails the compliance of revenues, expenditures, assets and liabilities in line with the approved budget to ensure its effectiveness, value for money and efficiency, PFMA (2012). Control of funds and financial decisions in the county government has been enhanced using approved budget and Integrated Financial Management Information system (IFMIS). Control of funds ensures effectiveness and efficiency of operations, by safeguarding assets prevention and detection of frauds and reducing the financial risk exposure

### **2.4 Empirical Review**

Boex and Muga (2004) while studying on the indicators of financial condition for local authorities in Tanzania found that there exists a positive relationship between financial management practices in local authorities and its corresponding financial performance. They used a population of 122 local government authority and descriptive statistics as their research design. They used the following ration the expenditure outrun ratio, the annual audit opinion of the audit office and the percentage of queries on expenditure questioned by the National Audit office.

Ngaruro (2013) in his study of the relationship between the financial planning and the financial performance of Public service organisations in Kenya. The study concluded that there was a significant positive relationship between financial planning and financial performance. He found that financial planning facilitates revenue growth. He used census sampling and therefore studied 47 managers drawn from commercially oriented parastatal organisation, data collection was through the use of questionnaire which could have given room to bias results.

Coker and Adams (2012) in their study of the challenges of expanding internally generated revenues in Nigeria attributed poor financial performance to the dependency on Federal government allocation which emanated from deliberate attempt by local citizens to evade taxation thus lowering local government revenues. The study also found that lack of qualified personnel, lack of autonomy in the management of financial resources, political interference, and corruption, lack of transparency and accountability and poor financial reporting. Their study supported the view that financial performance may be affected by other factors which are difficult to measure.

Maphalla (2015) did a study to ascertain the financial performance of South Africa local municipalities and deduced an existing relationship between the size of the municipality and the financial performance. There was also a substantial relationship between the reliance of revenue with financial performance of the organisation. He used all the 278 municipality as sample and examined the financial statements of the year 2013/2014.

Dollery, Byrnes & Crase (2008) did a study of local government failures in Australia, there area of focus was on five main sources of local government failure. While financial management and governance, council revenue and council expenditure could be measured, other external factors like democratic factors could not be measured. They used net liabilities on municipality, the operating surplus or deficiency and the levels of debt borrowing in the study. Other ratios that were used were debtor's collection, interest coverage and cashflow. The use of these ratios are recommended by the National Treasury of South Africa.

Ritonga (2014) did a study in modelling the financial condition of local government in indonesia used audited financial statements of local government between 2007-2010. The study used both primary data and secondary data. The secondary data was audited financial statements. The population was 530 local governments. The sample used was 162 respondents for questionnaire with a disregard for incomplete questionnaires and 420 local government with clean financial statements.

Dennis (2004) did a study about the relationship between state governments financial capacity in the USA and the states government financial condition. 1600 American cities and simple average of four indicators were used. Financial management practices based on a survey of a sample of 500 Chief Finance Officers. The study concluded that there was no significant relationship between local government financial performance and financial management practices.

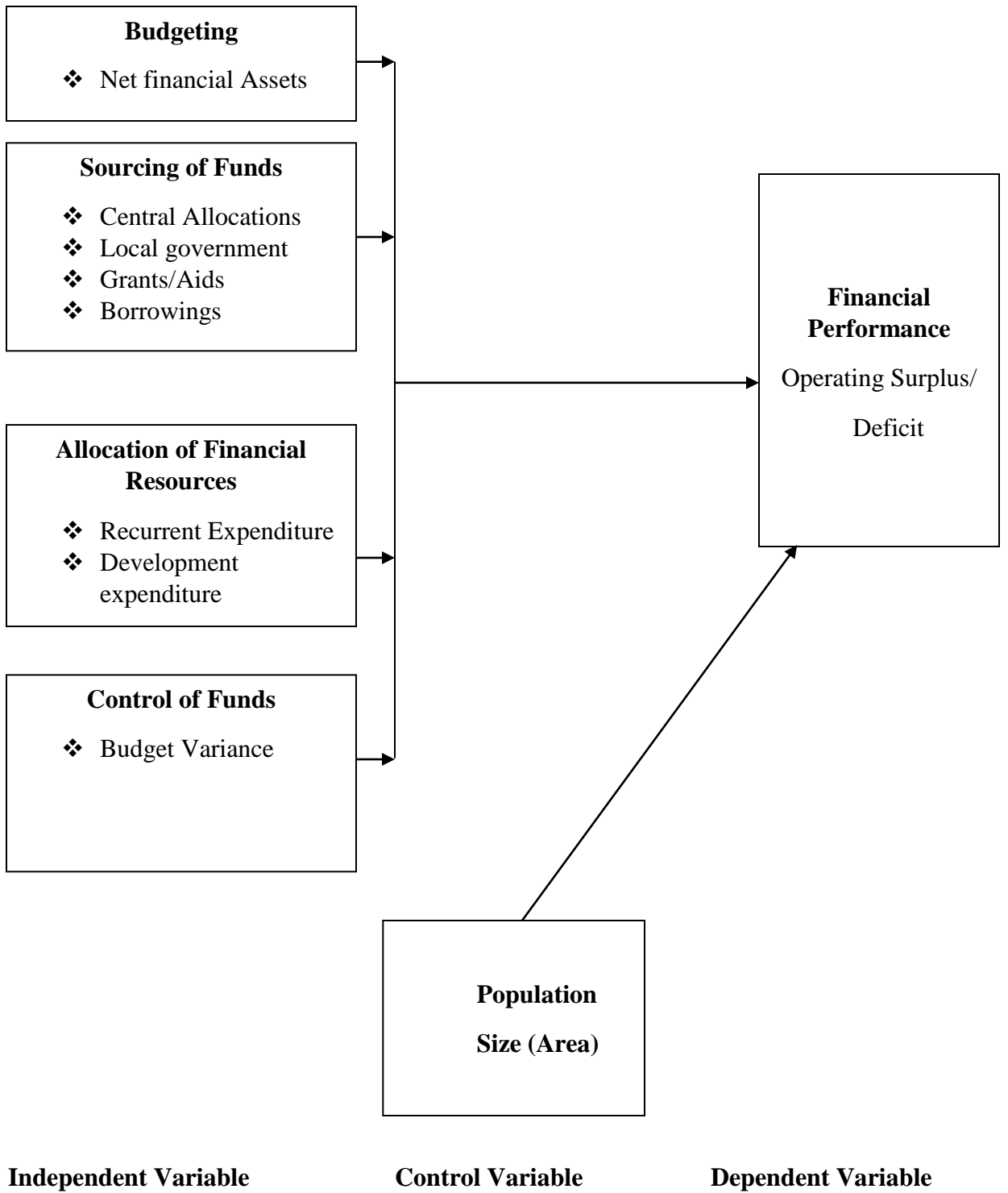
Coggburn and Schneider (2001) in their study to analyze the relationship between the quality of management and the performance of budget for local government in the United States. They established a significant relationship between financial performance and financial management. Singer (2004) in their study found a minimal significant relationship between local government condition and financial management practices in the United States.

Golda (2013) in her study on the effect of financial management practices to financial performance of the Kenya Medical Training college, found that there existed a significant relationship between financial management practices and financial performance. The study used primary data and had a population of 201 and a sample of 60 respondents.

## **2.5 Conceptual Framework**

Bryman and Bell (2015) defines conceptual framework as a concise description of phenomenon under study accompanied by a graphical or visual depiction of the major variables of the study. Young (2009) suggested that a conceptual framework is an illustration which shows all the variables in a study and how they are related. Financial performance is the dependent variable while the independent variables are financial planning, sourcing of funds, and allocation of funds as shown in Figure 2.1

Figure 2.1: Conceptual Framework



## **2.6 Summary of Literature Review and Gaps**

The literature reviewed the effect of financial management practices on financial performance of County Governments in Kenya. This study has relied on agency theory and stewardship theory to explain the relationship between financial management practices and financial performance of county Governments in Kenya. These Financial management practices were budgeting, sourcing of funds, allocation of financial resources and control of funds. Review of literature generally agrees that there is a significant relationship between these independent variables and financial performance. However, Studies done in this area relied heavily on primary data and therefore, there was need to replicate the same study within the Kenya jurisdiction to test this empirical evidence and provide further empirical evidence on agency and stewardship theories.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

The chapter provides an explanation of the research design, the target population, the sample and sampling technique that will be used and the rationale for selecting the sampling technique used, source of data to be used, the data collection and data analysis method.

### **3.2 Research Design**

This study used cross sectional research design. This is a research design for a group of variables that make comparisons at a single point in time. This research design was best suited for this study as it is carried out for County Governments in Kenya and the data was readily available to the public from the KENAO and OCOB. Descriptive design was chosen since it helps a researcher determine the underlying relationship between two variables.

### **3.3 Population**

The population consisted of all 47 County governments of Kenya, as currently established in the Constitution of Kenya 2010. These 47 Counties have varying heterogeneous characteristics in terms of revenue allocation from the National Government, size and revenue collection. Population is an assortment of homogeneous individuals and objects which will be the focal point of scientific research. The study used census research design which involves data collection for every member of the population.

### **3.5 Data Collection**

This study relied on secondary data. This is available on OCOB website, under reports, county reports. The financial statements were for the year 2015/2016 the latest publication of financial statements and were obtained from the website of OCOB, for the control variables the study relied on population projections for the year 2015 from the Kenya National Bureau of statistics (KNBS) website, the reason for using the 2015 projection data was because the last census that was carried out by KNBS was in 2009. The data on area per county was found on CRA website.

Secondary data was preferred because it was available on websites of mandated organizations and therefore can be corroborated. Choice of secondary data was also relevant since the measurement involved a specified duration of time. The data was analyzed to generate descriptive statistics and avoid dishonest responses in the case questionnaire involves sensitive financial matters.

### **3.6 Data Analysis**

The following regression analysis was applied to test the relationship between the financial management practices and financial performance of County Governments in Kenya. The statistical package for social sciences version (SPSS) 23 was used to analyze the data. Kothari and Gang (2014) proposed that at the time of developing a research plan a guideline must be set that will give a bearing of how data collection will have done, which data analysis tools to use and how the same will be presented.



Data Analysis which entails data cleaning, error proofing and correction of errors will be summarized into information that is often useful to a decision maker. This study employed the multiple regression analysis model. Fraenkel and Wallen, (2014) states that multiple regression is used to examine the relationship between variables and is used to predict the value of the one variable based on the value of the other.

The multiple regression equation is as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

**Y** = Financial Performance

**$\alpha$**  = Constant

**$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$  &  **$\beta_6$**  = Partial regression coefficient**

**X<sub>1</sub>** = Budgeting

**X<sub>2</sub>** = Sourcing of Funds

**X<sub>3</sub>** = Allocation of Financial Resources

**X<sub>4</sub>** = Control of funds

**X<sub>5</sub>** = Population per county

**X<sub>6</sub>** = Size of the county

**$\epsilon$**  = error term

### 3.6.1 Measurement of Variables

| Measure                 | Financial Indicator             | Formula  |
|-------------------------|---------------------------------|--|
| Allocation of resources | Expenditure Absorption Rate     | $\frac{\text{Budgeted expense} \times 100}{\text{Actual expense}}$ |
| Budgeting               | Revenue Deficit                 | Budgeted Revenue Less Actual Revenue                               |
| Control of funds        | Budget Variance                 | Operating Surplus/Deficit  |
| Financial performance   | Budgetary Solvency Ratio        | $\frac{\text{Total Revenues}}{\text{Total Expenditures}}$          |
| Sources of funds        | Inverse of the dependency ratio | $\frac{\text{Own revenue}}{\text{Government Allocation}}$          |

### 3.6.2 Test of Significance

The study sought to find out the effect of the relationship between financial management practices and financial performance of County Governments in Kenya. Correlation coefficient (r) was calculated to ascertain the strength and the direction of the relationship between financial performance and budgeting, source of funds, allocation of funds and control of funds. Coefficient of determination ( $R^2$ ) which measures how close data is to line of best fit derived from a regression equation was used to measure the significance of regression. The significance was tested at 5%. The one-way ANOVA (analysis of Variance) was used to compares means among two independent variables.

### **3.6.3 Diagnostics Tests**

Homoscedasticity was tested using Levene test, this is a measure of whether the relationship between the dependent and independent variances is the same. Levene test at  $\alpha= 0.05$  indicates that the data group lacks equal variances. Autocorrelation was tested using the Durbin Watson statistic this value is always between zero and four. The variance inflation factor (VIF) and the tolerance which is the reciprocal of VIF was used to measure multi collinearity. This is a situation that occurs where two or three predictor models are highly correlated and this effectively makes it difficult to determine the contribution of each predictor variable. The multicollinearity assumption has VIF value of Maximum 10 (Garson, 2012).

## **CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION**

### **4.1 Introduction**

In this chapter, the results gathered from the financial statements have been presented and analyzed. The data was from all the 47 county governments in Kenya for the financial year 2015/2016. Further we used data from the KNBS to obtain the projected population per county for year 2015 and the area in KM<sup>2</sup> per county. This chapter expounds on the data analysis, findings, interpretations and presentations.

### **4.2 Descriptive Statistics**

Descriptive statistics encompasses minimum, maximum, mean, standard deviation, skewness and kurtosis. Mean is the measure of central tendency that describes the most typical value in a set of values. The accuracy within a set of values on the other hand is measured by the standard error. Skewness measures symmetry or the lack of it. Kurtosis is the measures of peak-ness of data in a normal distribution (Cooper and Shindler, 2008).

The descriptive statistics are presented in table 4.1.

**Table 4.1: Descriptive Statistics**

|                         | N         | Mean      | Std. Deviation | Skewness  |            | Kurtosis  |            |
|-------------------------|-----------|-----------|----------------|-----------|------------|-----------|------------|
|                         | Statistic | Statistic | Statistic      | Statistic | Std. Error | Statistic | Std. Error |
| Financial Performance   | 47        | 1.1860    | .13370         | 1.042     | .347       | 1.196     | .681       |
| Budgeting               | 47        | 19.0404   | 1.94201        | -1.681    | .347       | 3.743     | .681       |
| Source of Revenue       | 47        | .1055     | .14555         | 3.937     | .347       | 19.354    | .681       |
| Control of Funds        | 47        | 20.3379   | 1.38743        | -3.410    | .347       | 16.104    | .681       |
| Allocation of Resources | 47        | 126.481   | 16.21925       | 2.025     | .347       | 6.109     | .681       |
| Population Size         | 47        | 13.5745   | .61661         | -.586     | .347       | .076      | .681       |
| Valid N (listwise)      | 47        | 8.5585    | 1.32999        | .142      | .347       | -.348     | .681       |

Source: Research Data (2017)

### 4.3 Regression Analysis

A cross sectional multiple regression analysis was conducted on effects of financial management practices on financial performance of County Governments in Kenya for the financial year 2015/2016

**Table 4.2: Regression Coefficients<sup>a</sup>**

| Model                   | Unstandardized Coefficients |            | Standardized Coefficients | t      | Sig. |
|-------------------------|-----------------------------|------------|---------------------------|--------|------|
|                         | B                           | Std. Error | Beta                      |        |      |
| (Constant)              | .187                        | .285       |                           | .657   | .515 |
| Budgeting               | -.023                       | .005       | -.329                     | -4.686 | .000 |
| Source of Revenue       | -.035                       | .062       | -.039                     | -.568  | .573 |
| Control of Funds        | .019                        | .007       | .201                      | 2.607  | .013 |
| Allocation of Resources | .007                        | .001       | .799                      | 10.277 | .000 |
| Population Size         | .014                        | .015       | .064                      | .925   | .361 |
|                         | .002                        | .007       | .024                      | .350   | .728 |

a. Dependent Variable: Financial Performance

Source: Research Data (2017)

The regression model can be derived from table 4.2 as follows

$$Y=0.187 - 0.023X_1 -0.035X_2 + 0.019X_3 + 0.007X_4 + 0.014X_5 + 0.002X_6 + \varepsilon$$

Where:

Y= Financial performance (measured as a ratio of total revenue to total expenditure)

X<sub>1</sub>=Budgeting measured by Natural log of Budgeted Revenue Less Actual Revenue

X<sub>2</sub>=Sources of Revenue measured by the ratio of own revenue to Government allocation

X<sub>3</sub>=Control of funds measured by Natural log of total revenue less total Expenditure

X<sub>4</sub>=Allocation of resources measured by the ratio of budgeted expense to total expenditure

X<sub>5</sub>=Population per county measured as a Natural log of the population

X<sub>6</sub>=Size of the County measured by Natural log of area per KM<sup>2</sup>

Budgeting, Control of funds and population measures were transformed into Natural logarithm. Natural logarithm was used for these measures that had absolute figures which were so high and so that they could be compared to other variables that were in ratio. The model above postulates that the financial performance of county governments in Kenya is 0.187 holding all other factors constant. Further the study concludes that holding other independent variables constant, a decrease in the budgeted revenue would cause a subsequent decrease of 0.023 in the financial performance of county governments. Subsequently unit decreases in the ratio of own revenue sources to government allocation would cause a decrease of financial performance by 0.035. A unit increase of the Natural log of total revenue less total expenditure would cause an increase of financial performance by 0.019. A unit increase of the ratio of budgeted expenditure to total

expenditures would cause a subsequent increase in the financial performance by 0.007. Overall the size and the sources of revenue did not have a statistically insignificant since they are less than 0.05.

#### 4.3.1 Coefficient of Determination

**Table 4.3: Model Summary<sup>b</sup>**

| Model | R                 | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics |               |
|-------|-------------------|----------|-------------------|----------------------------|-------------------|---------------|
|       |                   |          |                   |                            | R Square Change   | Durbin-Watson |
| 1     | .916 <sup>a</sup> | 0.839    | 0.815             | 0.05754                    | 0.839             | 2.703         |

a. Predictors: (Constant), Size, Allocation of Resources, Source of Revenue, Budgeting, Population, Control of Funds

a. Dependent Variable: Financial Performance

Source: Research Data (2017)

Coefficient of Determination is used to explain the extent to which changes in the dependent variable (financial performance) can be explained by the change in the independent variables. The independent variables explain 83.9% of the variations in financial performance as represented by R squared. This implies that other factors not included in this study contribute 16.1% of the variation in financial performance. The adjusted R squared is at 0.815 meaning that the model covered 81.5% in the variation of financial performance. Only 18.5% cannot be explained by the joint effect of the set variables (De Vaus, 2002).

### 4.3.2 Analysis of Variance (ANOVA)

To ascertain the strength of the model in explaining the relationship between the dependent variable (Financial Performance) and the Independent variables (budgeting, sourcing of funds, allocation of funds and control of funds), the study conducted one way ANOVA as per table 4.3. Significance F from the table indicates the usefulness from the overall regression model at 5% level of significance. Where the p value is less than the alpha it is concluded that there was a significant relationship between the financial performance and financial management practices in the study

**Table 4.4: ANOVA<sup>a</sup>**

| Model        | Sum of Squares | df | Mean Square | F     | Sig.              |
|--------------|----------------|----|-------------|-------|-------------------|
| 1 Regression | .690           | 6  | .115        | 38.33 | .000 <sup>b</sup> |
| Residual     | .132           | 40 | .003        |       |                   |
| Total        | .822           | 46 |             |       |                   |

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Size, Allocation of Resources, Source of Revenue, Budgeting, Population, Control of Funds

*Source: Research Data (2017)*

### 4.4 Diagnostic Tests

Durbin Watson was used to test autocorrelation and returned a result of 2.73 and this ranges between zero and four, therefore the conclusion is that there was no autocorrelation. The significance is less than 0.05 indicating that there is a significant relationship between the dependent and the independent variables that were used in the study. The Variance inflation factor (VIF) was used to test multicollinearity. This is a situation where the correlation among the independent variables are strong a situation that in undesirable in research, since we are not able to know the individual contribution of each predictor variable.



If model  $VIF > 10$  there is MultiCollinearity. MultiCollinearity was not in existence since all the data was less than 10 for all independent variables. Levene test was used to test for Homogeneity. The test was not significant at  $\alpha = 0.05$  confirming that the data group lacked equal variances.

**Table 4.5: Multicollinearity & Homogeneity Test**

| Model                   | Collinearity Statistics |        | Homogeneity |
|-------------------------|-------------------------|--------|-------------|
|                         | Tolerance               | VIF    | Levene Test |
| Assumption is Met if    |                         | Max 10 | $p > 0.05$  |
| 1 (Constant)            |                         |        |             |
| Budgeting               | .817                    | 1.223  | 0           |
| Source of Revenue       | .873                    | 1.146  | 2.446       |
| Control of Funds        | .680                    | 1.472  | 0           |
| Allocation of Resources | .667                    | 1.500  | 0           |
| Population              | .853                    | 1.172  | 0.546       |
| Size                    | .857                    | 1.167  | 0           |

Dependent Variable: Financial Performance

Source: Research Data (2017)

#### 4.5 Discussion of Research Findings

The objective of the study was to establish the effect of financial management practices on financial performance of County Governments in Kenya. From the regression model, the adjusted R squared is at 0.815 meaning that the model covered 81.5% in the variation of financial performance. Only 18.5% cannot be explained by the joint effect of the set variables (De Vaus, 2002). The study deduced that budgeting, control of funds, allocation of funds and the population had a statistically significant effect on financial performance. The study established the intercept of 0.187 as a constant.

The adjusted R squared was 0.815 indicating 81.5% of financial performance that is influenced by the independent variables, which implies that 18.5% is accounted for random variations and different variables beyond the scope of this study. The study established that budgeting which was measured by the natural log of budgeted revenue less actual revenue was -0.0023, meaning that it negatively and significantly influenced the financial performance of County Governments in Kenya, this study is in line with that of Ngaruro (2012) which found budgeting to have a significant influence of financial performance. Further the study established sources of revenue had the coefficient of the ratio of own revenue to Government allocation as negative 0.035, this negatively influenced financial performance; however, there was no statistically significant influence on the financial performance as the significance level was more than 0.05. Although diversification of revenue sources could increase the revenue base the same did not translate to increased financial performance

Allocation of funds had the greatest effect on financial performance with a standardized beta of 0.799 was measured by the Natural log of total revenue less total expenditure and its coefficient was 0.019 meaning an increase in allocation of fund would lead to a proportionate increase in the financial performance. it had a positive and significant influence on financial performance since its significance was less than 0.05. The coefficient of the ratio of budgeted expenditure to total expenditures was 0.007 meaning it had a positive and significant influence on financial performance. The F significance is less than the alpha which concludes that there is a significance relationship between the dependent and the independent variable.

Control of funds was found to have a very strong and positive significant effect on financial performance and it had a standardized beta of 0.201. The effect of control of funds was consistent with those done by Musya (2014) in her study on the effect of internal control on revenues on county government performance. Population on the other had was found to be statistically insignificant to financial performance of county government since its significance was more than 0.05 these findings are in line with those of Dennis (2004) An increase in the population would affect the financial performance of the county government by 0.19, these findings are in line with those ones of Maphalla (2015) who found that an increase in population had a significant impact on financial performance. Increase in population would mean a higher revenue base and increase in the expenditure levels to cater for amenities.

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter summarizes research findings and the conclusions drawn from the findings. In addition, recommendations and areas of further study are also represented in this chapter.

### **5.2 Summary of Findings**

The study sought to establish the effect of financial management practices and financial performance of county governments in Kenya. The test carried out involved descriptive and inferential statistics at 5% significance level. Accordingly, the regression model the study concluded that there was a significant relationship between financial management practices and financial performance as indicated by the adjusted  $R^2$  which accounts for 81.5%. According to the regression model the study established that the following variables budgeting, source of Revenue, control of funds and allocation of resources influence financial performance of county government.

#### **5.2.1 Budgeting**

The study used the natural logarithm of budgeted revenue less actual revenue for the financial year 2015/2016 to measure budgeting. From the study, this figure had a mean of 19.0404 and a standard deviation of 1.94201. A decrease in actual revenues compared to the budgeted revenues would cause a proportionate decrease in the financial performance by a proportion of 0.023.

The study concluded that budgeting had a significant influence on financial performance since the significance was at 0.000 which is less than 0.05. The standardized beta was -0.329 which showed the strength of budgeting to financial performance.

### **5.2.2 Source of Revenue**

Sources of Revenue measured by the ratio of own revenue to Government allocation. It had an unstandardized beta of -0.35, which implies a unit decrease in the ratio of own revenue sources to government allocation would cause a decrease of financial performance by 0.35. The significance was at 0.573 which is greater than 0.05 hence the relationship between sources of revenue and financial performance is statistically insignificant. What this concludes is that regardless of the source of revenue be it from Government a financial performance will not be affected.

### **5.2.3 Control of funds**

Control of funds was measured by the Natural log of total revenue less total expenditure to determine how it influences financial performance. This variable returned a figure of 0.019 meaning that financial performance of county governments in Kenya was influenced positively by a proportionate increase in this variable by 0.19. Control of funds had a mean of 21.93 and standard deviation of 20.3379. Control of funds had a significant influence on financial performance since the significance 0.13 was less than 0.05. The strength of this variable to the dependent variable was 0.201 as indicated by the standardized beta and it ranked the second.

#### **5.2.4 Allocation of Resources**

Allocation of resources was measured by the ratio of budgeted expense to total expenditure, the allocation of resources ratio was 0.007 which means that a change in this variable of would cause a proportionate increase by 0.007. The significance was 0.000 which is less than 0.05 therefore indicating that this variable had a significant effect to financial performance. It also means that allocation of resources had a positive significant influence on financial performance and an increase of 0.007 will cause a proportionate increase in financial performance. This was the independent variable with the strongest effect as indicated by its standardized beta of 0.799.

#### **5.2.5 Control Variables**

Population per county was measured as a Natural log of the population and had an unstandardized beta of 0.014, this means that an increase in the population would result to a proportionate increase in financial performance by 0.014. The strength of population variable to financial performance was 0.064 which means it was statistically insignificant. Population had a significance of 0.361 which was also statistically insignificant.

Size of the County was measured by Natural log of area per  $\text{KM}^2$  and had an unstandardized beta of 0.002. Size had a significance of 0.728 which is more than 0.05 consequently there was no statistically significant influence on financial performance and size of the county and financial performance and population per county since they are more than 0.05. These findings are in line with the conclusion in the study carried out by (Dennis, 2004) and (Ritonga, 2014).

### **5.3 Conclusion**

From the results, the researcher concluded that financial management practices influence the financial performance of county government in Kenya. Control of funds and allocation of resources although statistically insignificant contributed positively to financial performance. However, Budgeting, sources of funds and the size in area which is static and dependent on the landmass and they didn't have a statistically significant impact on financial performance. This means that regardless of the source of funds, be it from locally sourced revenue, from donor funds or from government allocations, the financial performance is not affected. There was no multicollinearity, auto collinearity and homogeneity in the variables used in this study.

### **5.4 Recommendations**

Since the study only accounted for 81.5% of financial performance, policy stakeholders, the county Governments KENAO and OCOB should look out for other factors that affect financial performance with desire to influence financial performance positively. Since population had a p value of -0.016 influence on financial performance the study recommends an increase in revenues to counter its effect of financial performance. Counties should also strive to achieve their budgeted revenues since a decrease in revenues from the targeted revenue affects the overall financial performance of the counties. Counties should also look at the factors that affect missed revenue targets including creating diverse sources of revenues. Control of funds is also a key area that counties should look for since it has a significant impact on financial performance. This should be done thoroughly and consistently. Counties should consistently strive to

expense all their projected expenditures. There should also be a deliberate attempt to allocate more of the funds to development expenditure as opposed to recurrent expenditure. For the financial year 2015/2016 most of the county allocations were 70-90% on recurrent expenditures.

### **5.5 Limitations of the Study**

The study was limited to the financial year 2015/2016, because financial statements for the year 2016/2017 were not available and because the population projections availed by KNBS were for the year 2015 and this study used a cross sectional apart from the longitudinal approach. The study did not consider other variables which affect financial management practices that could not be quantified as indicated by the regression analysis. These include political interference, bureaucracy and level of education of county executives working in Finance department.

### **5.6 Suggestions for Further Research**

Further studies can be carried out on effect of non-financial management practices on financial performance in County Government since this study only looked at the financial management practices yet non-financial management practices also affect financial performance. Further research on the effect of financial management practices on financial performance may also be replicated in other industries which are drivers of the economy. Further study could also be carried out on effect of financial management practices on financial performance of county governments of Kenya and Tanzania and comparing the results of these two different jurisdictions and with an extended period.



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## APPENDICES

### APPENDIX 1: LAND AREA PER COUNTY

| NO | COUNTY          | AREA(KM <sup>2</sup> ) |
|----|-----------------|------------------------|
| 1  | MOMBASA         | 212.5                  |
| 2  | KWALE           | 8,270.30               |
| 3  | KILIFI          | 12,245.90              |
| 4  | TANA RIVER      | 35,375.80              |
| 5  | LAMU            | 6,497.70               |
| 6  | TAITA TATEVA    | 17,083.90              |
| 7  | GARISSA         | 45,720.20              |
| 8  | WAJIR           | 55,840.60              |
| 9  | MANDERA         | 25,797.70              |
| 10 | MARSABIT        | 66,923.10              |
| 11 | ISIOLO          | 25,336.10              |
| 12 | MERU            | 6,930.10               |
| 13 | THARAKA         | 2,409.50               |
| 14 | EMBU            | 2,555.90               |
| 15 | KITUI           | 24,385.10              |
| 16 | MACHAKOS        | 5,952.90               |
| 17 | MAKUENI         | 8,008.90               |
| 18 | NYANDARUA       | 3,107.70               |
| 19 | NYERI           | 2,361.00               |
| 20 | KIRINYAGA       | 1,205.40               |
| 21 | MURANG'A        | 2,325.80               |
| 22 | KIAMBU          | 2,449.20               |
| 23 | TURKANA         | 71,597.80              |
| 24 | WEST POKOT      | 8,418.20               |
| 25 | SAMBURU         | 20,182.50              |
| 26 | TRANS NZOIA     | 2,469.90               |
| 27 | UASIN GISHU     | 2,955.30               |
| 28 | ELGEYO MARAKWET | 3,049.70               |
| 29 | NANDI           | 2,884.50               |
| 30 | BARINGO         | 11,075.30              |
| 31 | LAIKIPIA        | 8,696.10               |
| 32 | NAKURU          | 7,509.50               |

|    |          |           |
|----|----------|-----------|
| 33 | NAROK    | 17,921.20 |
| 34 | KAJIADO  | 21,292.70 |
| 35 | KERICHO  | 2,454.50  |
| 36 | BOMET    | 1,997.90  |
| 37 | KAKAMEGA | 3,033.80  |
| 38 | VIHIGA   | 531.3     |
| 39 | BUNGOMA  | 2,206.90  |
| 40 | BUSIA    | 1,628.40  |
| 41 | SIAYA    | 2,496.10  |
| 42 | KISUMU   | 2,009.50  |
| 43 | HOMA BAY | 3,154.70  |
| 44 | MIGORI   | 2,586.40  |
| 45 | KISII    | 1,317.90  |
| 46 | NYAMIRA  | 912.5     |
| 47 | NAIROBI  | 694.9     |

Source: CRA, 2015

**APPENDIX 2: POPULATION PROJECTIONS BY COUNTY**

| <b>NO</b> | <b>COUNTY</b>   | <b>YEAR 2014</b> | <b>YEAR 2015</b> | <b>YEAR 2020</b> |
|-----------|-----------------|------------------|------------------|------------------|
| 1         | MOMBASA         | 1,106,444        | 1,145,259        | 1,347,440        |
| 2         | KWALE           | 765,831          | 792,698          | 932,641          |
| 3         | KILIFI          | 1,307,185        | 1,353,042        | 1,591,901        |
| 4         | TANA RIVER      | 282,958          | 292,885          | 344,595          |
| 5         | LAMU            | 119,641          | 123,842          | 145,698          |
| 6         | TAITA TATEVA    | 334,042          | 347,195          | 408,492          |
| 7         | GARISSA         | 416,389          | 423,931          | 463,891          |
| 8         | WAJIR           | 442,371          | 450,385          | 492,839          |
| 9         | MANDERA         | 685,510          | 697,922          | 763,716          |
| 10        | MARSABIT        | 309,557          | 312,698          | 328,774          |
| 11        | ISIOLO          | 152,332          | 153,875          | 161,773          |
| 12        | MERU            | 1,441,361        | 1,455,849        | 1,530,043        |
| 13        | THARAKA         | 388,202          | 392,094          | 412,033          |
| 14        | EMBU            | 548,569          | 554,079          | 582,297          |
| 15        | KITUI           | 1,075,866        | 1,086,599        | 1,141,592        |
| 16        | MACHAKOS        | 1,167,480        | 1,179,215        | 1,239,309        |
| 17        | MAKUENI         | 939,879          | 949,298          | 997,546          |
| 18        | NYANDARUA       | 659,848          | 673,000          | 740,314          |
| 19        | NYERI           | 767,560          | 782,864          | 861,162          |
| 20        | KIRINYAGA       | 584,377          | 596,030          | 655,639          |
| 21        | MURANG'A        | 1,042,929        | 1,063,721        | 1,170,109        |
| 22        | KIAMBU          | 1,795,999        | 1,831,800        | 2,015,014        |
| 23        | TURKANA         | 1,009,225        | 1,045,579        | 1,238,136        |
| 24        | WEST POKOT      | 605,033          | 626,832          | 742,267          |
| 25        | SAMBURU         | 264,284          | 273,804          | 324,230          |
| 26        | TRANS NZOIA     | 966,197          | 1,001,005        | 1,185,347        |
| 27        | UASIN GISHU     | 1,054,805        | 1,092,803        | 1,294,058        |
| 28        | ELGEYO MARAKWET | 436,631          | 452,360          | 535,665          |
| 29        | NANDI           | 888,435          | 920,445          | 1,089,953        |
| 30        | BARINGO         | 655,641          | 679,256          | 804,346          |
| 31        | LAIKIPIA        | 470,965          | 487,934          | 577,791          |
| 32        | NAKURU          | 1,891,739        | 1,959,880        | 2,320,819        |
| 33        | NAROK           | 1,003,672        | 1,039,837        | 1,231,331        |
| 34        | KAJIADO         | 810,918          | 840,127          | 994,853          |

|    |          |           |           |           |
|----|----------|-----------|-----------|-----------|
| 35 | KERICHO  | 887,659   | 919,637   | 1,045,996 |
| 36 | BOMET    | 861,397   | 892,429   | 1,015,048 |
| 37 | KAKAMEGA | 1,812,330 | 1,843,320 | 2,007,597 |
| 38 | VIHIGA   | 605,379   | 615,734   | 670,601   |
| 39 | BUNGOMA  | 1,500,990 | 1,526,655 | 1,662,709 |
| 40 | BUSIA    | 812,036   | 825,921   | 899,525   |
| 41 | SIAYA    | 941,724   | 963,007   | 1,070,797 |
| 42 | KISUMU   | 1,083,268 | 1,107,755 | 1,231,745 |
| 43 | HOMA BAY | 1,077,554 | 1,101,901 | 1,225,243 |
| 44 | MIGORI   | 1,025,422 | 1,048,602 | 1,165,974 |
| 45 | KISII    | 1,288,290 | 1,317,407 | 1,464,861 |
| 46 | NYAMIRA  | 668,863   | 683,979   | 760,541   |
| 47 | NAIROBI  | 4,004,400 | 4,232,087 | 5,433,002 |

Source: KNBS, 2017