Research Paper

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The Contribution of Financial Management Practices to Financial Challenges Facing Local Authorities in Service Delivery in Kenya

Management

KEYWORDS:

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ABSTRACT

The paper assesses the contribution of financial management practices to the financial distress faced by local authorities in Kenya. The presence of financial challenges in local authorities leads to poor service delivery and makes a local authority not to meet its mandate as stipulated in Cap 265 of our laws. Poor service delivery has its consequences which include a growing dissatisfaction of the community, suppliers, employees and all internal and external stakeholders. Financial challenges in local authorities exist in various forms. For instance local authorities are often unable to pay current liabilities such as salaries and short term obligation to creditors. In order to meet their short term financial obligations they are forced to operate on overdrafts with high interest rates hence compounding the problem. The study draws attention to financial management practices that may contribute to financial challenges in local authorities in Kenya. The population of the study comprises of 175 local authorities. A sample of 20 Local Authorities was selected using a stratified systematic sampling technique. A questionnaire was used to collect data from both the LAs officers and customers to these local authorities. The collected data was analyzed using descriptive statistics such as frequencies, mean, standard deviation. Ordinary Least Squares (OLS) was employed to study the causal relationships among all the variables in the model. In order to identify whether significant difference exist among the three categories of financially distressed local authorities, Analysis of Variance (ANOVA) was used. Qualitative responses were analyzed using content analysis. Results indicated that the local authorities were financially distressed. In addition, financial management practices of local authorities were found to be poor and this may have led to the state of financial distress. The study recommended that best practices in the area of financial management such as proper internal controls, institution and adherence to budgets, regular and accurate financial reporting are crucial in averting or reversing the trend of fiscal distress in local authorities.

INTRODUCTION

1.1 Background of the Study

The terms Local Governments and Local Authorities are used interchangeably in this thesis proposal so as to avoid being bogged down by terminological quagmires. By definition, local government means an intra-sovereign governmental unit within the sovereign state dealing mainly with local affairs, administered by local authorities and subordinate to the state government (Khan and Ara, 2006, Jahan, 1997).

The formation of local government may have been motivated by the need to reduce bureaucracy and the growth of institutional power to the detriment of the citizens. This is exemplified by the quote from a letter from Thomas Jefferson to J. Cabell, 1816.

"The way to have good and safe government is not to trust it all to one, but to divide it among the many, distributing to everyone exactly the function he is competent to. Let the National Government be entrusted with the defense of the nation and its foreign and federal relations; the State governments with the civil rights, laws, police, and administration of what concerns the State generally; the counties with the local concerns of the counties, and each ward direct the interests within itself." --Thomas Jefferson to J. Cabell, 1816, Writings 14:421--423

1.1.0 Mandate of Local Authorities

The mandate of local authorities is to bring governance closer to the people as advocated by the decentralization theorem which states that each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision (Oates, 1972). They provide cultural; educational; management, research, commerce and political services. They also do offer employment, best health facilities and boost the country's economy (UN-HABITAT, 2004). For instance, the City Council of Nairobi, the largest Local Authority in Kenya, produces more than half of the country's Gross Domestic Product (IEA, 2009).

The Cities Alliance Report (Menkveld, and Cobbett, 2007) and Local Authority services (Cap 265, chapter 3 section 5), describes Local Government as providing platforms for productivity, entrepreneurship and economic modernization, poverty reduction and practicing good governance. Local authorities also are mandated to enable administrative convenience and expediency as advocated by Stigler's menu theorem. The presence of financial challenges in local authorities leads to poor service delivery and makes a local authority not to meet its mandate (Freire and Polese, 2003). Poor service delivery has its consequences which include a growing dissatisfaction of the community to the point that they form local associations to voice their concerns; a good example is the Karengata Resident Association (Omamo, 1995). On the extreme side, residents may withhold the rates owed to the local authorities as a measure to enforce compliance with service delivery (IEA, 2009).

1.1.2 Local Authorities in developing countries

Schoeman (2011) investigated fiscal performance in terms of own-revenue collection and sustainability of local municipalities in South Africa. This study noted that a large number of municipalities do not comply with the requirement that a "reasonable" amount of current expenditures be financed by means of own resources. Furthermore, local governments finances are featured by substantial variance as far as collection of own income is concerned.

Fjelstad,Henjewele, Mwambe, Ngalewa, Nygaard (2004) attempted to analyze changes in Tanzanian local authorities' capacity for financial management and revenue enhancement, and changes relating to governance, including accountability and responsiveness of the local government. The study concluded that there is a causal relationship between financial management of local authorities and governance. Another study by Sennoga (2004) on relationship between local government revenues and expenditures in Uganda noted that increases in revenues lead to less than proportionate increases in local government expenditures which then lead to credence of the flypaper effect.

Jonga and Chirisa (2009) observed that it was lamentable that the messy reality of governance in Zimbabwe and the economic meltdown in the country has rendered most of the councils un-creditworthy to local and international banks, leaving the borrowing powers by urban councils in the hands of central government to the detriment of rapid decision-making let alone service delivery. The researcher further asserted that almost all towns and cities in Zimbabwe have been grappling with raising sufficient revenues for capital and recurrent expenditures.

De Visser, Steytler and Machingauta (2010) assert that given Zimbabwe's overall perilous financial state, local governments have not been spared. Furthermore, almost all local authorities have faced insurmountable challenges in raising enough funding to ensure effective service delivery ever since independence. He further shows that most of the challenges revolve around the failure to ensure effective financial management systems resulting in levying sub-economic tariffs, the failure to ensure cost recovery on essential services, the failure to recover debts in a hyper-inflation environment, and the lack of skilled staff.

However, Miring'uh and Mwakio (2006) assert that there is overwhelming evidence that recent reform measures, including RRI have failed to stop immense hemorrhage of revenue at the City Hall. A recent damning forensic report by the Kenya Anti-Corruption Commission, states that City Hall continues to lose a huge portion of parking fees, land rates or rent to corrupt officials exploiting weak financial management systems (KACC, 2007). According to KACC (2007) says perpetrators of the rip-off at the Council had devised a complex system to block evidence of unremitted money estimated to be worth millions of shillings. Key to the racket is concealment of the paper work involving such money, including bouncing cheques, tempering with the numbering of parking fees receipts and the filing of fraudulent expenditure claims at the council's cash office (Osiche (2007), (Adero, 2007) , (KACC, 2007)

1.2 Statement of the Problem

Financial challenges in local authorities exist in various forms. For instance local authorities are often unable to pay current liabilities such as salaries and short term obligation to creditors (Omamo, 1995). In order to meet their short term financial obligations they are forced to operate on overdrafts with high interest rates. Local authorities are also unable to meet long term liabilities such as bank loans. An example of such financial challenges include those currently being experienced by Mombasa City council which is staggering under heavy borrowing as it owes the creditors a whooping Ksh 1.9 billion (Mombasa City Council Budget, 2011) while Nairobi City Council owes its creditors Kshs 5.3 billion (CCN Budget, 2011), just to mention but a few.

Furthermore financial challenges exist in the form of revenue deficits forcing the authorities to always rely on the central government for fiscal transfers such as Local Authority Transfer Fund- LATF (Omamo, 1995). Also Mcluskey and Fransen, (2005), Gachuru and Olima (1998) and (Muia, 2005) noted that the deficits in Local Authorities in Kenya were growing and that there was urgent need to arrest the situation.

Financial challenges in Kenyan local authorities have been a persistent phenomenon. For example, it was recorded in the Kenya Parliamentary sessions that local authorities were facing financial challenges due to a weak financial base (Hansard 2001). This led to the introduction of Local Authority Transfer Fund (LATF) as a move to strengthen the financial base. However, these policy instruments together with internal source of revenue have not mitigated the occurrence of financial challenges in local authorities. The persistence of this problem is exemplified in the quote from the Kenya Parliamentary session by Hansard (2000) which went on to record that;

"Mr. Speaker Sir, the Nairobi City Council is in a state of chronic financial distress. It has been spending beyond its means, and it has debt payments arrears that exceed its annual income, before even taking into account its large future debt repayment obligations". Kenya Parliamentary Hansard 15th June 2000, pg.1095.

The financial health of local authorities in local government is crucial in ensuring the sustainable delivery of services to the community (Capalbo et al, 2010). The Presence of financial challenges in LA's such as inability to pay salaries leads to staff demotivation (IEA, 2009); Muganda and Belle, 2009). This is manifested through shirking, laziness and corruption among the staff. This manifestation negatively affects the revenue collection which further compounds the problem of financial deficits (IEA, 2009).

However, studies on local authority financial challenges (for instance, IEA report (2009),Omamo (1995), Mcluskey and Fransen, (2005), Gachuru and Olima (1998) Ekwubi (2010)) in developing countries in general and Kenya in particular are inadequate because they do not exhaustively address the contribution of financial distress in local authorities. In addition, such studies are lacking in depth assessment and give generalized conclusions as far as a causal relationship between financial management practices and financial distress. In fact no adequate studies have been conducted specifically to establish the contribution of financial m,anagment practices to financial challenges facing local authorities in Kenya. This study therefore sought to bridge this evident research gap by investigating the contribution of financial challenges facing LA's in Kenya.

1.3 Objectives

1.3.1: General Objective

This study seeks to establish the contribution of financial management practices to financial challenges facing local authorities in Kenya

1.3.2: Specific Objectives

To investigate whether financial management practices such as

a) internal control processes
b) financial governance
c) financial reporting/ tracking
d) control systems
e) capital budgeting and the annual budgeting process ,leads to financial challenges facing local authorities in Kenya.

1.4 Research Questions

Do financial management practices contribute to financial challenges facing local authorities in Kenya?

2.1 THEORETICAL REVIEW

2.1.1 Financial Distress Theory

The term financial challenges and financial distress will be used interchangeably because they share the same connotation. According to Baldwin and Scott (1983, p. 505), ``when a firm's business deteriorates to the point where it cannot meet its financial obligations, the firm is said to have entered the state of financial distress. The first signals of distress are usually violations of debt covenants coupled with the omission or reduction of dividends''. Beaver (1966) defined financial distress as any of the following events: bankruptcy, bond default, bank account overdrawn, or nonpayment of a preferred stock dividend. On the other hand, Lau (1987) classified a firm into a five-state financial distress, that is, state 0: financial stability; state 1: omitting or reducing dividend payments more than 40% below previous year; state 2: technical default and default on loan payments; state 3: protection under the Bankruptcy Act; and state 4: bankruptcy and insolvency.

Financial distress theory asserts that financial distress can be subdivided into four sub-intervals: deterioration of performance, failure, insolvency, and default. Whereas deterioration and failure affect the profitability of the company, insolvency and default are rooted in its liquidity. Theoretically, the outcome of each interval can be positive, implying that the company breaks the downward trend, or negative indicating the continuing deterioration of the firm value and a movement downwards from one sub-interval of the spiral to another. In many real cases, when entering financial distress, the company traverses all the stages of decline (Mueller, 1986). The theory of financial distress may be useful in explaining the causes of financial challenges facing local authorities. In addition, it may be used to give indicators of financial distress in local authorities and how the challenges can be resolved.

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2.2: CONCEPTUAL FRAMEWORK

The current study considered several conceptual frameworks by other scholars on the causes of financial distress in local authorizes. The reviewed conceptual frameworks were critiqued and various variables were incorporated in the conceptual framework of the current study while others were discarded. The first model was from Park (2004). According to Parker (2004) internal causes of municipal bankruptcy include; internal fiscal mismanagement, political mismanagement, internal lack of structural leadership and internal lack of culture of inefficiency. The external contributors of fiscal distress according to Parkers Model Include; demographic changes, structural recessions, tax revolt, structural service demand, political pressure from creditors, interest group demand, judgment awards, and abrupt economic changes.

The second reviewed model that was from Capalbo et al (2010). Capalbo et al (2010) noted that the main causes of financial distress could be grouped in to two approaches, the social economic decline approach and the local management approach. The social economic decline approach assumes that causes of financial distress are external to local authorities and that they are beyond the control of local government officials. Such causes include: contraction of economic growth, movement of city dwellers to outskirts of the major cities, demographic changes such as increase in population, reduction in local business activity, unemployment and tax base erosion, bureaucracy and poor legislation. The local government approach assumes that incorrect managerial practices such as poor accounting and budgeting methods, incompetence and corruption among local officials, division of local governments in terms of political size and procedures and vulnerability of special interest groups. In conclusion, capalbo et al (2010) argues that financial distress does not arise because of one set of factors but arises due to a mix of both external and internal factors.

Carmeli (2011) shows that the sources of fiscal distress of local governments in Israel, may be classified into three major groups: structural or fixed (consists of local authorities' size, residents' socioeconomic status, and governmental resource allocation), organizational (consists of performance evaluation, transparency, and the role of the local government's management), and hybrid (consists of the relationship between the central and the local governments) factors. Incorporating the variables of Park (2004), Capalbo et al (2010) and Carmeli (2011), the current study came up with the below conceptual framework (figure 2.1).

Source: Researcher (2011).

2.2.1 Indicators of Financial Challenges (Distress)

The FRSB (2005) advanced a quadrilateral set of key financial indicators 'for assessing a council's financial sustainability'. These indicators were: (a) net financial liabilities as the 'key indicator of the council's indebtedness to other sectors of the economy'; (b) operating surplus or deficit as the 'key indicator of the intergenerational equity of the funding of the council's operations'; (c) net outlays on the renewal or replacement of existing assets as the 'key indicator of the intergenerational equity of the funding of the council's infrastructure renewal or replacement activities'; and (d) net borrowing or lending as the 'key indicator of the impact of the council's annual transactions – both operating and capital – upon the council's indebtedness to other sectors of the economy'.

A study by Boex and Muga (2004) used the following measures of financial performance to indicate the level of financial health of Tanzania Local Authorities; a) expenditure outrun ratio (or budget performance ratio), b) The annual audit opinion that is issued by the National Audit Office for each local government, c) the percentage of expenditures questioned by the NAO during the audit process. This study concluded that one can hypothesize that local authorities' financial management performance in Tanzania is a positive function of local administrative and managerial practices. For the purpose of the current study, the Key Performance Indicators identified by Boex and Muga (2004) shall be used to measure financial challenges facing local authorities in Kenya.

Given a likert scale of 1 to 5, local authorities scoring a mean of 0 to 1.65 were rated as lowly distressed LAs, those scoring above 1. 65 to 3.335 were termed as moderately distressed Las while those Las with a mean score of over 3.335 were described as highly distressed. However, the magnitude of the demarcation/ classifications may change according to the weighting system.

2.2.2. Financial Management Practices

Financial management is found in both private sector and public sector as it is an important activity in the management and sustainability of an institution. The definition of financial management depends on the type of institution and varies depending on whether it is a donor, the government or the private sector. However, the majority for the activities and the objectives of financial management appear to cut across all organizations. According to Lee, A.C., Lee, J.C. and Lee, C. (2009), there are two possible approaches in defining financial management, a descriptive one; and an analytical and operational one. From a descriptive standpoint, financial management is composed of three of the major policies of a firm: its investment, financing, and dividend policies. However, from an operational standpoint, financial management includes both short term financial management and long term financial management. Short term financial management includes the management of working capital items such as cash management, inventory management, accounts receivable management and the like (Lee et al , 2009). On the other hand, long term financial management is defined as financial management that encompasses essentially all decision making that has an impact over a period of one year or more(Lee et al, 2009).

Boex and Muga (2009) asserted that Local financial management practices are measured based on assessments of the local budgeting system, strategic planning system, fall-back system, accounting/reporting system, internal control system, and the local financial leadership system. The studies by Capalbo et al (2010), Carmeli (2008), Deal (2007), Frank and Dluhy (2003), Kloha, Weissert, and Kleine (2005) , Watson, Handley and Hassett (2005) confirmed that financial mismanagement contributes to financial distress in local authorities.

The current study attempted to adopt the following variables of financial management in local authorities that may lead to financial distress. These includes internal control processes, financial governance, financial reporting/ tracking and control systems, capital budgeting and the annual budgeting process.

3.0 RESEARCH METHODOLOGY

3.1. Research Design

Research design refers to how data collection and analysis are structured in order to meet the research objectives through empirical evidence economically (Chandran, 2004; Cooper and Schindler,2007). Social science research approaches are classified as descriptive, exploratory or explanatory (Kothari, 2004). The current study took a descriptive design, which required analysis of the financial management practices contributing to financial challenges facing local authorities in Kenya. Descriptive research, also known as statistical research, describes data and characteristics about a population of phenomenon being studied. It answers research questions who, what, where, when and how is the problem.

3.2 Population

Population is a large collection of individuals or objects that is the main focus of a scientific query (Mugenda & Mugenda, 2003; Hyndman, 2008; Castilo, 2009). In this study there are two types of population. These are target population and accessible population. For the purpose of this study the target population comprised of all 175 local authorities in Kenya, which included 3 cities, 43 Municipal Councils, 67 County Councils, and 62 Town Councils. Due to considerations in time and money a representative sample was selected from which conclusions were drawn was known as the accessible population (Mugenda & Mugenda, 2003). The accessible population was determined by the sampling frame and discussion with the researcher's supervisor.

3.3 Sample and Sampling Technique
A sample is a subset of a population (Hyndman, 2008, Marczyk, DeMatteo, Festinger, 2005). The study selected a sample of 20 local authorities. For each selected LA, 10 questionnaires was distributed to the relevant departments such as Administration, Treasurer, Audit, Human Resource Management, Works, ICT, Accounts and Public Relations depending on the council's establishment.

3.4 Sampling Technique
This study used probabilistic sampling techniques, specifically both stratified random sampling and simple random sampling. The study used lottery method recommended by Kothari, (2004) to pick ten percent of Local Authorities in every category. Stratified random sampling was preferred because; the population to be sampled was divided into homogenous groups based on characteristics considered important to the indicators being measured. Since the number of local authorities are scattered all over the country, this presented the study with a logistical problem. The study therefore used a sample of 20 LAs selected as follows;

Table: 3. 1: Population Sample

tLocal Authority	Total Number	Sample	Sample Percentage
City Councils	3	3	100%
Municipal Councils	43	4	10%
County Councils	67	7	10%
Town Councils	62	6	10%
Grand Total	175	20	

To select the sample of 20 LAs, stratified systematic sampling was used to select the 10th LA in every Stratum. The study targeted the town clerk of each of the 20 Local Authorities. The study also incorporated the views of middle level management from five departments in each local authority namely; 1) Treasury 2) Social Services, housing and public health 3) works/engineering 4) Environment 5) Others. The choice of middle level management was to act as a control for the response of the town clerks and because of their perceived lack of bias, impartiality in answering the study questions. In addition, they were more preferred than junior officers, since junior officers are perceived to be unaware of the pertinent issues affecting the Local Authorities.

The local authority customers were also included in the study to give a customer oriented perspective of the financial challenges facing local authorities. Six of the largest customers were picked from the list of customers provided by every local authority. The criterion for selecting the six customers per local authority was on the basis of customers visiting the local authority on the day. Therefore, such an approach was to yield 120 customers drawn from the 20 local authorities.

Table: 3. 2: Population Sampling Frame

tLocal Authority Department	Total Number
Town clerk	20
Treasury (middle managers)	20
Social Services, housing and public health(middle managers)	20
Works/Engineering(middle managers)	20
Environment(middle managers)	20
Others (middle managers)	100
Customers	120
Grand Total	320

3.5 Instruments
The instruments of data collection were through both open-ended and close-ended questionnaires.

3.7 Pilot Test
To maximise reliability of the instrument used, the survey was constructed as follows: 1) a pilot survey was conducted to ensure the reliability of the questionnaire; 2) each question was framed succinctly to reduce ambiguity and minimize bias, thereby ensuring the high statistical value of the data; and, 3) each participant in the pilot survey was asked to state their job position to make sure participation was at senior-manager level. In short, the pilot test sought to demonstrate convergent and indiscriminate validity for all the constructs and reveal that all the scales meet or exceed the reliability thresholds for more established research (Castillo, 2009). 2 LA's participated in the pilot study (Kiambu and Ruiru LAs).

The current study pilot tested the questionnaire on two local authorities namely Kiambu county council and Ruiru municipal council. A total of 21 questionaires (11 from Kiambu county council and 10 from Ruiru municipal council) were obtained. Reliability results for the financial management practices constructs representing the independent and dependent variables attracted a cronbach alpha statistics of more than 0.7. A cronbach alpha of 0.7 indicated that the data collection instrument is reliable. The reliability statistics are presented in table 3.2.

Table 3. 2:Reliability Statistics

Section	Numberof questionnares	Numberof items(questions)	Cronbach alpha	Comment
Financial management practices	21	10	0.834	Reliable

Descriptive statistics and Ordinary Least Squares (OLS) regression model prescribed by Faraway (2002), Cohen, West & Aiken, (2003) were used. OLS is useful in showing linear elasticity/sensitivity between independent and dependent variables (Cohen, West & Aiken, (2003). For instance, the current study would like to know the percentage by which responses on financial distress increases or decreases when responses on financial management practices change by 1 percent. Furthermore, OLS was useful in showing whether the identified linear relationship is significant or not.

$$Y = \alpha + \beta_1 X_1 + \varepsilon$$

Where Y= Financial Distress
α = constant (intercept)
β= slope (gradient) showing rate dependent variable is changing for each unit change of the independent variable.
X1= Financial Management practices

Creech (2011) asserts that one-factor ANOVA, also called one-way ANOVA is used when the study involves 3 or more levels of a single dependent variable. One factor Anova is preferred because the current study has three levels of financial distress (dependent variable) which requires and assessment of whether the means of the independent variables differ across the three levels of financial distress exhibited by local authorities. This made Anova gain superiority to Ordinary Least Squares Regression because OLS does not compare means. In addition, Anova, unlike other parametric tests such as student's tests, is quite robust against some deviation from the assumptions in parametric analysis. Specifically, Anova is robust against the parametric assumption that 1) the residuals (deviations from group means) have a normal distribution, 2) the variation is the same in each group.

In the current study, financial distress was decomposed into three levels a) severely distressed LAs/low financial health b) moderately distressed /moderate health LAs c) weakly distressed/high financial health. Given a likert scale of 1 to 5, local authorities scoring a mean of 0 to 1.65 were rated as lowly distressed LAs, those scoring above 1. 65 to 3.335 were termed as moderately distressed LA's while those LAs with a mean score of over 3.335 were described as highly distressed. However, the magnitude of the demarcation/classifications changed according to the weighting system.

The study expectations were that highly distressed/low financial health LAs may exhibit low scores of financial management practices. The expectations of the study are that lowly distressed/high financial health LAs may also exhibit high scores for financial management, practices. Therefore, to achieve the objective, the sign of the regression coefficient of financial management practices (X1) was checked whether it is consistently negative as expected in the study. The significance of the coefficient was also verified by checking the calculated p value against the conventional p value of 0.05 (Castillo, 2009).

A p value of less than 0.05 indicated that the independent variables (financial management practices (X1) are significant determinants of financial challenges facing LAs. To support the finding, Analysis of Variance (ANOVA) was conducted to check whether the mean response for the independent variables significantly differed across the three categories of financially distressed Local Authorities. If they did, then the study checked whether the means are largest for lowly distressed Local Authorities and least for severely distressed Local Authorities. Content analysis was also used to address the qualitative information obtained from both officers and customers.

4.0 DATA ANALYSIS
The number of questionnaires that were administered was 320 in number. Out of these, 200 were administered to officers/employees and 120 were administered to customers. A total of 295 questionnaires were properly filled and returned, which included 188 questionnaires from the officers and 107 questionnaires from the customers. This represented an overall successful response rate of 92%.

Table 4. 1: Response Rate

	Successful	Unsuccessful	Total
Officers/ Employees	188 (94%)	12(6%)	200
Customers	107 (89%)	13(11%)	120
Total	295 (92%)	25(8%)	320

4. 1: Financial Distress in Local Authorities
The study attempted to confirm whether local authorities were under financial distress. Results in figure 4.1 reveal that the majority (49%)of respondents from the officers category agreed with the statement that the local authority budget out run ratio is high (meaning that the Local Authority always spends more than it has budgeted), the salary to total operating revenue ratio is high (meaning that the salary expense take more than 70% portion of the operating revenue) (45%), the net debt to total operating revenue ratio is high (meaning the Local Authority is highly indebted) (49%), the interest expense to total operating revenue ratio is high (meaning that the Local Authority may be over reliant on overdrafts) (46%), the council financial statements are frequently qualified (meaning that they are frequently not given a good bill of health) (51%),The National Audit Office queries a large percentage of expenditures during the audit process (meaning that there seems to be expenditures that demonstrate fiscal stress) (52%). These findings imply that local authorities are in a state of financial distress since majority of the local authorities' scores highly on the measures of financial distress. Figure 4.5 presents the detailed findings.

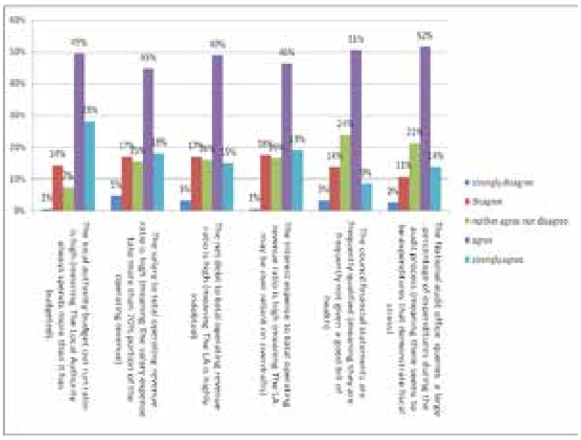

Figure 4. 1: Financial Distress in Local Authorities

4. 2: Financial Distress and Category of Local Authority
Descriptive results in table 4.2 revealed that municipal councils have the highest level of distress (11.758) followed by city councils (11.578), county councils (10.896) and town councils (9.815). However, as indicated by table 4.3, there is no significant difference in levels of distress among the different types of councils (F=1.589, P value =0.194). The finding implies that financial distress is not a preserve of a specific category of local authority but crosscuts across all categories of local authorities. Table 4.4 which shows multiple comparison between categories indicated that municipal councils have a significantly higher level of distress compared to town councils (p value =0.04).

Table 4. 2: Descriptive Statistics for Distress across Local Authority Categories

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean		Minimum	Maximum
					Lower Bound	Upper Bound		
City Councils	22	11.5788	3.68200	.78500	9.9463	13.2113	3.35	16.68
Municipal Councils	91	11.7583	4.05012	.42457	10.9148	12.6018	1.59	21.32
County Councils	42	10.8960	4.60582	.71069	9.4608	12.3313	3.29	19.38
Town Councils	25	9.8151	4.17826	.83565	8.0904	11.5398	1.59	17.66
Total	180	11.2653	4.18320	.31180	10.6500	11.8805	1.59	21.32

Table 4. 3: Anova for Distress across Categories of Local Authorities

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	82.584	3	27.528	1.589	.194
Within Groups	3049.760	176	17.328		
Total	3132.344	179			

Table 4. 4: Multiple Comparisons of Distress

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(I) Category type	(J) Category type	Mean Difference (I-J)	Std. Error	Sig.	95% Confidence Interval	
					Lower Bound	Upper Bound
City Councills	Municipal Councils	-.17952	.98897	.856	-2.1313	1.7723
	County Councils	.68272	1.09555	.534	-1.4794	2.8448
	Town Councils	1.76370	1.21687	.149	-.6378	4.1652
Municipal Councils	City Councills	.17952	.98897	.856	-1.7723	2.1313
	County Councils	.86224	.77653	.268	-.6703	2.3947
	Town Councils	1.94322*	.93997	.040	.0882	3.7983
County Councils	City Councills	-.68272	1.09555	.534	-2.8448	1.4794
	Municipal Councils	-.86224	.77653	.268	-2.3947	.6703
	Town Councils	1.08098	1.05152	.305	-.9942	3.1562
Town Councils	City Councills	-1.76370	1.21687	.149	-4.1652	.6378
	Municipal Councils	-1.94322*	.93997	.040	-3.7983	-.0882
	County Councils	-1.08098	1.05152	.305	-3.1562	.9942

*. The mean difference is significant at the 0.05 level.

4.3: Customers Awareness that Local Authorities Suffer from Financial Challenges

As illustrated in Figure 4.2, customers for local authorities were also asked to express their opinion on whether they were aware that local authorities were suffering from financial distress. A majority of customers (70%) indicated that they were aware that local authorities were facing financial challenges.

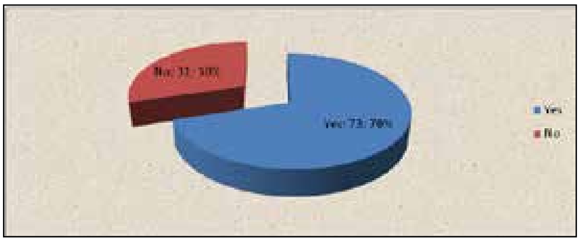

Figure 4. 2: Customers Awareness that Local Authorities Suffer from Financial Challenges

The results from officers and customers of local authorities indicate that local authorities in Kenya suffer from financial distress. The findings are consistent with those in Dollery (2009),PriceWaterhouseCoopers Report (2006), Boex and Muga (2004), Capalbo, Grossi, Ianni, Sargiacomo (2010), Carmeli (2008), Deal (2007), Frank and Dluhy (2003), Kloha, Weissert, and Kleine (2005), Watson, Handley and Hassett (2005), Honadle (2006), Wunsch (2008),Institute of Economic Affairs (2009), Schoeman (2011),Jonga and Chirisa (2009) and Sennoga (2004). The above studies found that local authorities of the countries under study suffered from financial distress.

4.4. Financial Management Practices and Financial Distress

One of the objectives of this study was to determine if financial management practices contributed to the financial distress of local authorities. In order, to achieve this objective, descriptive statistics were carried out followed by a regression equation. Analysis of Variance (Anova) was also carried in order to support the study findings. Furthermore, the results of Local Authorities officials were contrasted and compared with those of customers in order to give a clear view of the relationship. Results in figure 4.3 indicated that a majority (39%) of officers agreed with the statement that local authorities suffer from ineffective systems for detecting fraud. Twenty three percent (23%) of respondents in the officer's category also strongly agreed to the statement that local authorities suffer from ineffective systems for detecting fraud. This brought to a total of 62% who agreed or strongly agreed with that statement.

Results in figure 4.3 further indicated that a majority (37%) of respondents in the officers category agreed with the statement that local authorities have insufficient and inappropriate internal controls in place. Seventeen percent (17%) of the respondents strongly agreed to the statement, bringing to a total of 54% of those officers who agreed or strongly agreed with the statement that authorities have insufficient and inappropriate internal controls in place.

The finding implies that local authorities have not put in place effective systems and internal controls in place to detect and prevent fraud and this may have had led to the resultant financial distress being witnessed in many local authorities. The findings agree with those of Miring'uh and Mwakio (2006) who asserted that there is overwhelming evidence that recent reform measures, including Rapid Results Initiative have failed to stop immense hemorrhage of revenue at the City Hall. The study results also compare well with that of a recent damning forensic report by the Kenya Anti-Corruption Commission (KACC), which stated that City Hall continues to lose a huge portion of parking fees, land rates or rent to corrupt officials exploiting weak financial management systems. According to KACC (2007), perpetrators of the rip-off at the Council had devised a complex system to block evidence of unremitted money estimated to be worth millions of shillings. Furthermore, KACC (2007) asserted that key to the racket is concealment of the paper work involving such money, including bouncing cheques, tempering with the numbering of parking fees receipts and the filing of fraudulent expenditure claims at the council's cash office.

Results also indicated that while 30% of the officers agreed to the statement that legally constituted procurement committees do not exist, another 14% strongly agreed to the statement bringing to a total of 44% of those officers who agreed or strongly agreed that local authorizes do not have legally constituted procurement committees. The finding implies that local authority's award tenders arbitrarily without adhering to the Public Procurement Act 2005. The Public Procurement Act 2005 part IV section 29 subsection 1 to 4 stipulates that for each procurement, the procuring entity shall use open tendering under Part V or an alternative procurement procedure under Part VI, subsection 2 states that a procuring entity may use an alternative procurement procedure only if that procedure is allowed under Part VI, subsection 3 states that a procuring entity may use restricted tendering or direct procurement as an alternative procurement procedure only if, before using that procedure, the procuring entity ; (a) obtains the written approval of its tender committee; and (b) records in writing the reasons for using the alternative procurement procedure. Subsection 4 states that a procuring entity shall use such standard tender documents as may be prescribed.

Part IV section 40 subsection 1 also stipulates that no person, agent or employee shall be involved in any corrupt practice in any procurement proceeding. Furthermore Part IV section 42 subsection 1 stipulates that no person shall collude or attempt to collude with any other person to make any proposed price higher than would otherwise have been the case; to have that other person refrain from submitting a tender, proposal or quotation or withdraw or change a tender, proposal or quotation; or, to submit a tender, proposal or quotation with a specified price or with any specified inclusions or exclusions. Failure to comply with Procurement Act may have resulted into inflation of tender prices, the rising cost of service delivery and corruption. The rising cost of service delivery may partly explain the financial distress in most local authorities.

Results in figure 4.3 indicate that a majority of respondents in the officers category disagreed with the statement that the internal audit function does not exist (48%), monthly and yearly budget analysis is not done (50%), financial reports are not produced regularly (44%) and financial statements are not pre-

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pared in accordance with IFRS and legal requirements (46%). However, the study also observed that a total of 31%, 26%, 26%, and 21% agreed to the statements which sends doubt as to the effectiveness of the financial management practices. For instance, the internal audit function may exist but that would not mean that it is effective in curbing financial malpractices such as frauds and irregular procurement. Monthly and yearly budget analysis may be done but a question of whether the variances are investigated and an action plan for remedying variances drafted arise. Financial reports may be produced regularly but the question of whether they are accurate and relevant abounds. Financial statement may be prepared in line with international financial reporting standards (IFRS) and legal requirements, but it remains to be seen whether the figures in the financial statements represent reality and the actual position of the local authority.

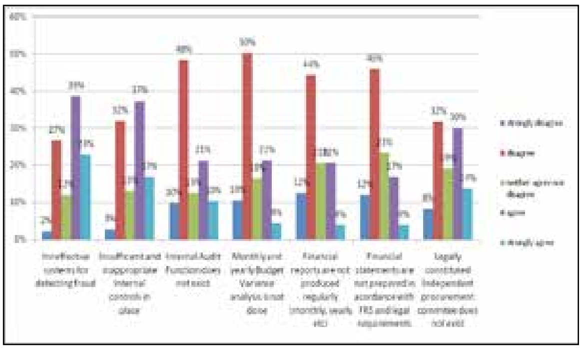

Figure 4. 3: Financial Management Practices

4.4.1: Officers Rating the Financial Management Practices in the Local Authority

Respondents from the officer's category were asked how they would rate the financial management practices in the local authority. Results in figure 4.4 indicated that a strong majority(69%) of respondents in the officers category rated the financial management practices as poor. This response supported other findings in this study that show that local authorities have poor financial management practices.

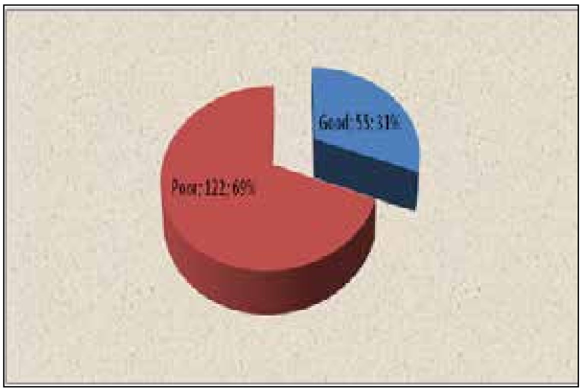

Figure 4. 4: Rating the Financial Management Practices in the Local Authority

Local authority officers were also asked to explain why they rated financial management practices poorly. Some of the responses include;

"Funds are expended without adherence to the budget"," Some chief officers do not adhere to approved budget for the fly. "There is no proper management", "Because some of staffs dont have enough skills and experience", "Political interference, no independence", "Due to political interference", "Because they are not effective", "Because sometimes they dont give the financial in weekly or daily "," Its poor because of there way of collecting the taxes", "No proper control and record keeping", "Audit Department is always Compromised", "Most of the funds Collected dont reach the office"," A lot of Audit Queries", "High Level of Corruption"," Corruption is high"," No Transparency"," No Capacities", "No Professionalism", "Delay in Salary payment and remunerations", "interference by political wing makes system fail"," "some audit procedures are not followed", "the councilors should keep away from management"" the practice in finance dept is very corrupt"," lack of proper budgeting and reporting", "the official work only under pressure" "the systems are down and cannot detect fraud"," disinterested chief officers and susceptibility to political whims"," financial books and records are not properly kept"," clerks have autonomous powers".

Content analysis indicate that most of the officers rated the financial management poorly because of lack of internal controls, the ineffectiveness and the lack of independence of the audit department, corruption, lack of independence and political interference from political wing, poor budgeting and lack of adherence to already set budgets, lack of capacity, skills and competence of finance officers, laxity in financial reporting among others.

The local authority officers were requested to suggest recommendations for improvement of local authorities' financial management practices. Some of the suggested recommendations included;

"I recommend that all local authorities to be absorbed by county government to come up with a very strong internal control system"," Decentralization."," Institute a strong financial system for monitoring the funds i.e input & output of resources"," Having and implementing Sufficient Controls within each department in the local Authorities", "Adequate Measures Should be taken to help detect fraud."," Funds collected by local authorities should be controlled by people who are not thirsty."," To automate services through LAFOMS."," All Local Authorities Computerise their systems and connect to the website for transparency", "Periodic Audits Spot Checks, quarterly Financial Reports, and use of LAIFOMS(Local Authority Intergrated Financial Management Systems)"," I would Recommend for Systems Financial Management for example LAIFOMS on a full blast."," Ensure LAIFOMS are installed in all L.A." Deployment of more staff in internal audit and account department."," Constituted Independent strong Audit Department.", The people with financial management should have trained in the discipline, so as to have good financial management practice.", "To employ staffs who are qualified in financial management."," People Collecting funds Should be taught Something about money"" ," improve means of collecting revenues ", Councils to be free from civic wing", "Effective and disciplined principals."," I will recommend that, they should check on qualifications", "They should invite Auditors from outside for proper checks and balances.", "To make and improve their budgets effectively in every Step they forecast each and every year".

Content analysis indicates that the most frequently suggested recommendations for improvements of financial management practices include decentralization and devolution, institution of strong internal controls, address capacity and independence of audit and financial department through training, qualifications based hiring and resistance to interference from councilors who are in political wings. Furthermore, the officers frequently suggested that automation of financial processes and the implementation of LAIFOMS would help to improve financial management practices. In addition, revenue collection methods should be improved and so should the budget practices.

4.4.2: Customer's opinion on whether financial distress could be attributed to poor financial management practices

Customers were also requested to give an opinion on whether poor financial management practices contributed to the financial distress of local authorities. Results in figure 4.5 indicated that a majority (54%) of customers strongly agreed with the statement that poor financial management practices such as lack of internal controls, budgeting and reporting contributed to the financial challenges local authorities. The results also indicated that 33% of customers agreed with the statement that poor financial management practices such as lack of internal controls, budgeting and reporting contributed to the financial challenges local authorities, bringing to a total of overwhelming majority 87% of the customers who agreed or strongly agreed with the statement.

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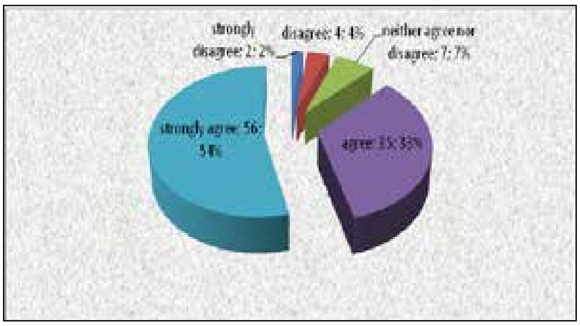

Figure 4. 5: Poor Financial Management Practices Such as Lack of Internal Controls, Budgeting and Reporting are to Blame for the Financial Challenges of Local Authorities

4.4.3: Relationship Between Financial Management Practice and Financial Distress

Regression analysis was conducted to empirically determine whether financial management practices were a significant determinant of financial distress in local authorities. Regression results in table 4.5 indicated the goodness of fit for the regression between financial management practices and financial distress is satisfactory. An R squared of 0.977 indicates that 97.7% of the variances in the financial distress are explained by the variances in the financial management practices. The relationship between financial management practices is negative and significant (b1=-0.916, p value, 0.000). This implies that an increase in the effectiveness of financial management practices by 1 unit leads to a decrease in financial distress by 0.916. The regression equation is as follows;

Financial Distress = 22.995 - 0.916* Financial Management Practices

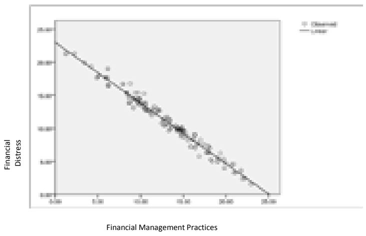

Figure 4. 6: Linear Relationship Between Financial Distress and Financial Management Practices

Anova results in table 4.6 indicated that there exists a significant difference in financial management practices between the three categories of financially distressed local authorities (F=378.79, P value=0.000). Group statistics in table 4.7 indicated that highly distressed local authorities have a significantly lower mean score on financial management practices (7.74). Moderately distressed local authorities have a mean score of 12.68 for financial management practices while lowly distressed local authorities have the highest mean score for financial management practices (17.95). Table 4.8 indicated that financial management practices differed significantly across the three levels of distressed local authorities. The findings imply that financial management practices contribute to financial distress.

Table 4. 6: Descriptive for Financial Management Practices
Table 4. 7: ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	3231.173	2	1615.586	378.790	.000
Within Groups	789.048	185	4.265		
Total	4020.221	187			

Table 4. 8: Multiple Comparisons

(I) Distress_ Category	(J) Distress_ Category	Mean Difference (I-J)	Std. Error	Sig.	95% Confidence Interval	
					Lower Bound	Upper Bound
Lowly Distressed	Moderately Distressed	5.266*	.370	.000	4.54	5.99
	Highly Distressed	10.210*	.371	.000	9.48	10.94
Moderately Distressed	Lowly Distressed	-5.266*	.370	.000	-5.99	-4.54
	Highly Distressed	4.944*	.367	.000	4.22	5.67
Highly Distressed	Lowly Distressed	-10.210*	.371	.000	-10.94	-9.48
	Moderately Distressed	-4.944*	.367	.000	-5.67	-4.22

*. The mean difference is significant at the 0.05 level.

The results from the descriptive statistics, regression analysis and Anova indicate that financial management is a significant determinant of financial distress in local authorities. The findings are consistent with those of Boex and Muga (2009) Capalbo et al (2010), Carmeli (2008), Deal (2007), Frank and Dluhy (2003), Kloha, Weissert, and Kleine (2005),Watson, Handley and Hassett (2005) who confirmed that financial mismanagement contributes to financial distress in local authorities.

5.0 SUMMARY, CONCLUSIONS AND RECCOMMENDATIONS

5.1: Summary of the findings

The study investigated the state of financial distress in local authorities and concluded that local authorities were highly distressed since majority of the local authorities' scores highly on the indicators of financial distress. Specifically, the study found out that the local authorities always spend more than budgeted and salaries took more than 70% of the operating revenue. Furthermore, the local authorities were highly indebted and relied heavily on over drafts. It was also observed that the financial statements of local authorizes are rarely given a good bill of health by auditors. Auditors also questioned a large percentage of the expenditures, an indication that the local authorities were under fiscal stress.

The finding indicated that local authorities had ineffective financial management practices. This observation was arrived at since the local authorities did not have effective systems to detect and prevent fraud. In addition, local authorities had poor internal controls, poor budgeting practices, poor procurement practices and poor financial reporting practices. Results further indicated that ineffective financial management practices had contributed to the financial distress of local authorities.

5.2: Conclusions of the Study

5.2.1: Financial Distress in Local Authorities

It was possible to conclude from the study findings that local authorities in Kenya face financial distress. The conclusion was arrived at since majority of the local authorities scored highly on the six measures of financial distress. The study also concludes that financial distress crosscuts across the four categories of local authorities. It can be inferred from the study findings that the local authorities in Kenya suffer from a high budget out run ratio. Hence, Local Authorities in Kenya spend more than what is stipulated in the budget. It is also not uncommon to see cases of local authorities whose salary to total operating revenue ratio is high. Such Local authorities have a salary expense that takes take more than 70% portion of the operating revenue.

The net debt to total operating revenue ratio for majority of the local Authorities in Kenya is high which a sign of local authority high indebtedness. The Interest expense to total operating revenue ratio for majority of local authorities is high which signifies that local authorities may be over reliant on overdrafts. It is possible to conclude that the local authority financial statements are frequently qualified since they are not frequently given a good bill of health. It is possible to infer from this study that the National audit office queries a large percentage of expenditures during the audit process since the expenditures demonstrate fiscal stress.

5.2.2: Contribution of Financial Management Practices to Financial Distress

The study concludes that the financial management practices of local authorities are poor and ineffective. This is because local authorities have not put in place effective systems and internal controls in place to detect and prevent fraud and this had led to the resultant financial distress being witnessed in many local authorities. It was also possible to conclude that local authority's award tenders arbitrarily since legally constituted procurement committees do not exist.

The study concludes that there exists a significant difference in financial management practices between the three categories of financially distressed local authorities with highly distressed local authorities having a significantly lower mean score on financial management practices compared to moderately distressed local .Lowly distressed local authorities have the highest mean score for financial management practices and this findings imply that financial management practices contribute to financial distress. There exists a negative significant relationship between financial management practices and the financial distress of local authorities. Given the regression and anova results, the study concludes that poor financial management practices may have been responsible fro the financial distress of local authorities.

5.3: Recommendations of the Study

The study recommendations are in line with the objectives, findings and conclusions of the study. Both the recommendations from the officers and from the customers were taken in to account in formulation the specific recommendations that would inforTm decision making.

5.3.1: Recommendations for Improvement of Financial Management Practices

Local authority officers recommended that various measures need to be put in place to in order to improve financial management practices. Some of the recommendations included;

I) Decentralization and devolution of financial and operational services.
II) Institution of strong internal controls,
III) Address capacity and independence of audit and financial department through training,
IV) Qualifications based hiring and resistance to interference from councilors who are in political wings.
V) Automation of financial processes and the implementation of LAIFOMS would help to improve financial management practiceTs.
VI) In addition, revenue collection methods should be improved.

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