INTERNAL CONTROLS AND FINANCIAL PERFORMANCE OF COUNTY GOVERNMENT OF LAMU, KENYA

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ABSTRACT

Satisfactory performance of Kenyan county governments financially is of great essence for accelerated economic development particularly in the grassroot level. A major concern several years after transition in to devolution has been the increasingly dismal financial performance of several county governments especially when assessed in terms of their own source revenues, pending bills and also the capacity to fund county services among other performance measures. The County Government of Lamu is among the county governments that have witnessed financial performance challenges and a key contributor to such concerns is weak internal control systems within the county government. Yet, research on how internal controls effect on county government's performance is not exhaustive. It is on this basis that the study sought to assess the effect of internal controls on the financial performance of the County Government of Lamu. Specifically the study sought to ascertain the effect of control environment on the financial performance of the County Government of Lamu. The study was underpinned by the agency theory and the stewardship theory. The study used an explanatory research design. The study targeted 6 executive committee members, 13 chief officers, 20 county directors and departmental/unit heads as well as 726 middle management level employees. To select the sample, stratified sampling method was used. The sample consisted of 2 executive committee members, 4 chief officers, 7 county directors and departmental/unit heads and 249 middle level staff, all totaling to 262. The study employed primary data and this was gathered through a questionnaire. Secondary data on own source revenue was collected using a secondary data collection template. Informed consent and voluntary participation, confidentiality and anonymity, and seeking approval and authorization to carry out the study are ethical issues that were considered. To analyze the data, both descriptive and inferential analysis were undertaken. Diagnostic tests consisted of normality, multicollinearity and heteroscedaciticity tests were conducted. Multiple linear regression analysis was conducted to compute regression estimates to be used in testing the outlined hypotheses. The results obtained was presented using tables. The study showed that control environment had the significance threshold of $p< 0.05$ hence had statistically significant effect on financial performance of County Government of Lamu. The study concluded that population of the respondents established to abundant magnitude with the fact that control environment indeed affected the financial performance of County Government of Lamu. The study recommended that County Government of Lamu should ensure that all staff show their commitment and competence on their responsibilities and should perform their duties as per laid out standards. It also recommends that all activities and operations in this county should be guided by high level of integrity and ethical values among the county employees. Furthermore, specific lines of authority and responsibilities should be checked to confirm adherence to the set policies and procedures.

Keywords: Control Environment, Internal Control, Risk Assessment, Control Activities and Financial Performance

INTRODUCTION

Over the years, devolution is among the critical reforms that have been adopted enhance performance within the public sector in various nations. In Kenya, as pointed out by Kubai (2015), the creation of county governments as stipulated in the country's constitution has been considered as a way of supporting development at the grassroots levels. Nonetheless, in discharging their mandate, these county governments are continually confronted with several challenges that have been detrimental to the financial health or performance of these county governments leading to unmet citizen aspirations (Makhaya & Maniagi, 2020).

Generally, it has emerged that weak internal control systems are among the leading factors that have exacerbated unsatisfactory financial performance in Kenyan county governments as underlined by Lerno (2016) and Bosharo and Abuga (2021) among others. Such systems have been linked to among others mismanagement, wastage and extravagant spending, collusion to fraud as well as the loss and embezzlement of revenues making it difficult for many county governments to efficiently discharge their mandate (Nyaga, 2016; Cheruiyot et al., 2017; Ngigi & Busolo, 2019). As such, strong internal controls in county governments are indispensable as they are a foundation for the realization of set financial and non-financial performance goals, objectives and targets (Musya, 2014; Kosaye, 2018; Galgallo, 2021).

This study aims to evaluate the effects internal controls have had on the financial health of the County Government of Lamu. This is among the county governments facing various financial performance challenges such as the inability to meet own source revenue targets which causes the county to over rely on equitable share as part of fiscal transfers (County Government of Lamu, 2020). Among the gaps leading to such challenges as highlighted by the Kenya School of Revenue Administration (2021) relates to internal control mechanisms such as the lack of daily revenue reporting mechanism and the failure to fully implement audit reports recommendations. Yet, there are no exhaustive studies on the combined impact of different internal control components on the financial stability of county governments in Kenya and more specifically, the County Government of Lamu. Hence, there a need to carry out this study.

Statement of the Problem

Since the transition to devolved system of governance, it has increasingly been acknowledged that the role of county governments in Kenya's economic development journey cannot be overemphasized. To develop and maintain public confidence in these county governments, their sustained financial performance is therefore, of great importance (Okongo, 2015). Many county governments in Kenya have recorded unsatisfactory financial performance over the years as highlighted in various reports published by the Auditor General and the Controller of Budget for the period 2014 to 2021 and the County Government of Lamu is among them.

The County Governments Consolidated Financial Statements as at 30th June 2020 for instance revealed that the County Government of Lamu was among the 10 lowest counties in terms of own revenue regeneration (Government of Kenya, 2020). An analysis of the revenue performance per stream from the FY 2016/17 reveals that though there has been sustained growth in the county's OSR, such growth has been erratic indicating the need for better revenue raising and management processes in county (County Government of Lamu, 2020). This had led to among others, the accumulation of huge pending bills and increased fiscal risks.

The Auditor General Report for the year ended 30th June, 2020 showed that the county government had pending bills amounting to Kshs. 167.16 million up from Kshs.101.78 million reported in 2018. As of 30th June 2021, the pending bills totaled Kshs. 196.17 million as reported by the Controller of Budget. The county government for the FY 2020/2021 also had a huge wage bill of 45.5% of the total expenditure exceeding the stipulated threshold of 35%. This posed a fiscal risk to the county government as it constrained the funding of county programmes and services. Among the challenges facing the county government leading to the highlighted financial performance trend in the County Government of Lamu is internal control systems that are weak and poorly utilized. The Auditor General for instance pointed out the lack of a risk management policy and information and communication technology policy, failure to appoint new audit committee and insufficient records (Office of the Auditor General, 2020).

These concerns justify the need for a study to investigate how the county government management can institute appropriate internal controls to reverse the stated financial performance trend. Based on the available literature, exhaustive studies on the combined effect of different internal control mechanisms or components on the financial health of county governments in Kenya and in particular, the County Government of Lamu are lacking. The examined literature has demonstrated that there has been extensive research on the effect of internal controls on the financial health of private sector firms including banks, manufacturing companies, SMEs and hotels among others. Some of these studies include that of Mogunde (2016), Akimana (2019), Mumba and Wekesa (2020) and Ouko and Atheru (2022). Adopting the findings from these studies in the context of the County Government of Lamu whose financial performance measures are quite different and the level of efficiency in implementing internal controls may be affected by different factors specific to the county context is therefore limited.

Though other studies such Lagat (2018), Waweru (2021) and Omar and Yussuf (2021) were conducted in public sector entities, the generalization of their findings to the current context is also limited due to differences in financial performance measures used and other underlying contextual factors. It is on this basis that this study aimed to assess the effect of control environment on the financial performance of the County Government of Lamu, Kenya.

General Objective of the Study

To assess the effect of internal controls on the financial performance of the County Government of Lamu, Kenya.

Specific Objective

To establish the effect of control environment on the financial performance of the County Government of Lamu, Kenya.

THEORETICAL REVIEW

Agency Theory

This theory was suggested by Ross (1973) and later advanced by Jensen and Mecklings (1976). It is anchored on an agency association in form of an agreement where one or more individuals (the master) appoint a different party known as the agent to perform a task on their behalf a move that incorporates the transfer of some power to make decisions to the agent (Sappington, 1991). The agent accepts to undertake particular responsibilities for the principal who on their part commits to rewarding the agent. This theory argues that the agent possesses more information compared to the principal and that this information asymmetry negatively impacts the principal's capacity to determine whether or not the agent is adequately serving their own interests (Mitnick, 2015).

The argument behind this theory is that so as to ensure that the interests of both the agent and the principal are harmonized, a comprehensive contract developed to address the interests of both parties (Van Thiel, 2016). The agency relationship is reinforced more when the principal employs experts and systems to track the activities of the agent (Kayode & Oyeshola, 2020). The theory further acknowledges that any information that is incomplete pertaining to the relationship, interests or the agent's job performance defined could be harmful and a moral hazard. Thus, this theory works on the supposition that the actions of both the principals and agents are rational and that these parties apply contracts with the aim of maximizing their wealth (Ssengooba, McPake & Palmer, 2012).

The applicability of this theory to this research is informed by the fact that internal controls are among the several tools adopted in organizations to deal with the agency issue by minimizing agency costs that emanate from the misalignment of the principal's and agent's goals and also when it is impossible to assume that the agent's behaviour is in line with the principal's goals. A distinctive way out to this, is the creation of mechanisms that compels the agent to align their behaviour using controls or incentives. Such mechanism is the introduction of internal controls that ward off any management irregularity and does not encourage overrides. Hence, internal controls can be used in the County Government of Lamu to ensure that county officials who work for the interests of Kenyan citizens and the government in general, take actions that are meant to enhance its financial performance. As such, this theory guides the general objective of this research.

Stewardship Theory

The origin of this theory is the research work undertaken by Schoorman & Donaldson (1997) who described stewards as individuals who protected and maximized the wealth of shareholders by boosting the performance of a firm since by such an action, the stewards' utility functions would also be maximized. On their part, Donaldson and Davis (1991) argued that the focus of stewardship theory was organizational management's ability to ensure that their individual goals were well aligned with that of the organization. Moreover, the two authors observed that stewards were pleased and inspired by the organization's success. When contrasted with the agency theory, this theory emphasizes not on individualism perspective but rather senior management's role being that of stewards who integrate their personal goals in to the organization (Donaldson & Davis, 1991).

In their further arguments, Jensen and Meckling (1994) stated that the costs involved in curbing agency problem and which are minimizing information asymmetry and associated moral hazard, was lower when there was the direct participation of organizational owners in managing a firm. This is because owner manager interests were naturally aligned with the opportunities for growth and risk. Thus, it is evident that stewardship theory completely contrasted agency theory and did not lay emphasis on the importance of incurring monitoring or agency cost which included among others, the establishment of an internal auditing function. Nonetheless, it was further noted by Donaldson and Davis (1991) that a firm's returns were enhanced by taking in to consideration or combining the two theories rather than separating them which implied the need for striking a balance by the firm management.

The stewardship theory anchors this study since it expresses the need for county government management or officials to work as stewards and place the interest of the public first when carrying out their duties. In so doing, they should ensure that internal controls in place are observed or upheld towards the realization of the set county goals and objectives so that the financial performance of the county government among other aspects are enhanced.

Empirical literature Review

Control Environment and Financial Performance

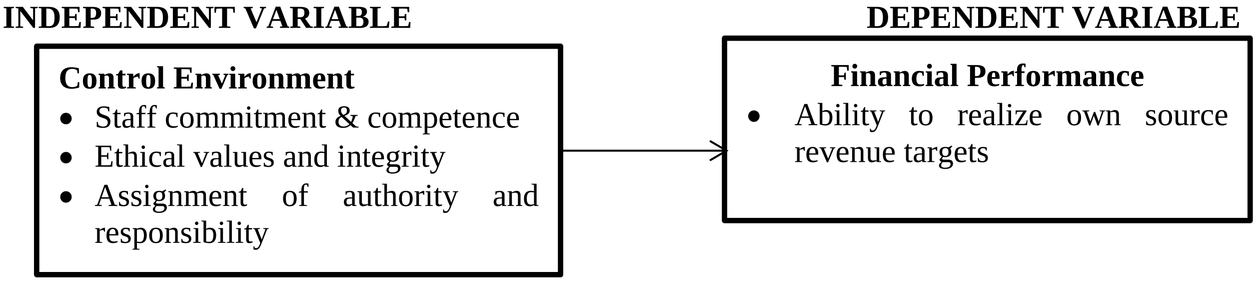
Waweru (2021) examined the ways in which the financial stability of Kenyan public entities was impacted by internal control environment. It was discovered that the country's public organizations' financial performance was influenced by the control environment, which included the staff's honesty, morals, and competence, the management's operational philosophy, and the delegation of responsibility. Control environment contributed to better financial performance by ensuring that the right the attitude needed to achieve organizational goals was set through policies, behaviors and actual governance. The study also noted that control environment assisted in minimizing the occurrence of fraud within the operations of these entities. It also enhanced efficiency in organizational operations.

Mumba and Wekesa (2020) noted that control environment conceptualized as staff competencies, management commitment and standards of conduct significantly boosted the financial health of hotels in the coastal region of Kenya. The control environment in these hotels provided the discipline and structure that was necessary for the accomplishment of their mission statements and this culminated to improved financial performance observed in their profitability and return on investment.

Omar and Yussuf (2021) also found that the control environment in learning institutions and which entailed commitment, competence, integrity and ethical values of persons performing assigned duties influenced financial performance. It not only improved the level of accountability in institutions but also ensured that they were efficient in delivering value and realizing their strategic targets and this ultimately enhanced their financial performance. The study viewed control environment as an enabling factor when it came to staff executing their tasks and also resulted to judicious compliance and increased efficiency in different operations.

Conceptual Framework

Figure 1: Conceptual Framework



Source: Researcher (2023)

Research Design

The study utilized an explanatory research design. The studies employing this research design normally attempt to find an explanation of the nature of a given link between variables (Rahi, 2017). The main focus in this case is to understand, explain, predict, and control the relationship that exists between variables (Creswell & Creswell, 2017). It has also been noted that the adoption of an explanatory research design ensures that a study goes over and above describing a situation or phenomena and that it tries to elucidate the reasons for a given phenomenon by finding causal relationships among variables (Boru, 2018).

Target Population

The County Government of Lamu employees placed at different levels was targeted. The targeted employees holding top or senior management positions consisted of the executive committee members, chief officers, county directors and departmental/unit heads. Employees at the middle management level were also considered. The choice of senior and middle level management county employees is informed by the fact that by the virtue of their positions, these employees are more likely to be more informed of the internal controls in place in the county as well as its financial performance when compared to staff at the lower level. Thus, the chosen county government employees are well positioned to provide the crucial information required to objectively carry out this study.

Sampling Design

The sampling frame for this study consisted of 765 employees of the County Government of Lamu. To determine the sample size, a formula advanced by Yamane (1967) was used to get a sample size of 262 employees from the County Government of Lamu which was selected using stratified sampling method to pick employees from the different levels.

Data Collection Instruments.

The study utilized primary and secondary data. Firsthand information from the County Government of Lamu employees was obtained using a questionnaire. The questionnaire composed of different sections containing questions related to the different study variables and also the bio profile of the employees. Most of the questions were structured in order to boost the response rate. The choice of a questionnaire in this study was informed by the lower costs and time resources required to administer the tool and the fact that it guaranteed the collection of objective data. Secondary data on the county government's OSR was collected from the Controller of Budget Reports for the past five financial years. A secondary data collection template was used.

Data Collection Procedure

The drop-and-pick technique was employed when distributing the questionnaire to enhance the response rate. This exercise was undertaken during the official working hours in the county government with the permission of the management. Two research assistants were used to administer the tools and follow ups through phone calls was done after a week of administering the tool.

Data Analysis and presentation

The entire process of analysis begun by preparing the data for analysis. This entailed doing the necessary editing, handling blank responses and then coding and categorizing the data so that it can be keyed in to SPSS, the selected statistical computer data analysis software. Both descriptive and inferential analysis were conducted. As for the main study variables, the mean and standard deviation was computed. Descriptive statistics according to Kaur, Stoltzfus and Yellapu (2018) allow researchers to give simple summaries regarding the sample and measures. Inferential analysis on the other hand entailed both correlation and regression analysis. The renowned Pearson correlation coefficients (r) was utilized to find out the link amongst the variables. A multiple regression analysis was applied in determining the impact of the explanatory variables on the financial performance of Lamu County Government.

The regression estimates namely the beta coefficients and their corresponding probability or significance values was assessed so as to determine the nature and significance of the effect of each of the mentioned internal controls on the financial performance of the County Government of Lamu. The critical significance value in this research was set at 0.05 (95% confidence level) and a calculated p value less than 0.05 implied a significant effect, otherwise, insignificant. Similar criteria were used in determining the significance of the correlation between the variables. The following equation represents the multiple linear regression model that was fitted in this study: -

$\mathrm{Y} = \beta_0 + \beta_1 \mathrm{C}_1 + \varepsilon$

Where:

$\mathrm{Y} =$ Financial Performance

$\beta_0 =$ Constant Term

$\beta_1 =$ Beta Coefficient

$\mathrm{X}_1 =$ Control Environment

$\varepsilon =$ Error Term

The findings were displayed through charts and tables.

RESEARCH FINDINGS AND DISCUSSIONS

Descriptive Statistics

Table 1: Descriptive Statistics of Control Environment

	N	Min	Max	Mean	Std. Dev
Working relationships	231	1.00	5.00	3.1732	.75491
Laid-out standards	231	2.00	5.00	3.1991	.73081
Core value of integrity	231	2.00	5.00	3.6061	.99815
Ethical values	231	2.00	5.00	3.3203	.96074
Competence	231	2.00	5.00	3.4675	.82753
Compliance	231	2.00	5.00	3.5368	.99878
Valid N (listwise)	231				

Source: Field Data (2023)

On the facet of all staff in this county government being committed to their jobs and have good working relationships among themselves, facts exhibited that popular participants concurred to a modest degree with the assertion at a mean of 3.173 with a disparity of 0.755. On the statement of whether all staff in the various units in this county government usually perform their duties as per the laid-out standards, popular participants concurred to a modest degree with a mean of 3.199 and a SD of 0.731. On the claim that integrity is this county government's guiding principle for all activities and operations, popular participants settled to a great magnitude with a mean of 3.606 and a SD of 0.998. On the statement of whether the county government management has instilled ethical values among all the county employees, facts exhibited that popular participants concurred to a modest level with a mean of 3.320 and a SD of 0.961. On the statement of whether all the employees in this county government are competent in carrying out their duties, facts exhibited that popular participants concurred to abundant level with a mean of 3.468 and a SD of 0.828. Regarding the claim that the county administration has established distinct lines of authority and responsibility to guarantee adherence to the established policies and procedures, facts exhibited that popular participants concurred to abundant level with a mean of 3.537 and a stan dev of 0.999.This research findings are similar to the findings of Omar and Yussuf (2021) who found that the control environment in learning institutions and which entailed commitment, competence, integrity and ethical values of persons performing assigned duties influenced financial performance.

Table 2: Descriptive Statistics of Financial Performance

	N	Min	Max	Mean	Std Dev
Revenue targets.	231	2.00	5.00	3.3030	.91554
Pay outstanding bills on time.	231	1.00	5.00	2.9610	.88133
Fund its operations	231	2.00	5.00	3.2814	.98402
Statutory requirements	231	2.00	5.00	3.3723	.86974
Financial obligations	231	2.00	5.00	3.4329	.75386
Valid N (listwise)	231				

Source: Field Data (2023)

On the statement of whether the county government has been successful in achieving its income goals, it was distinguished that popular of the participants concurred to a modest level with the account at a mean of 3.303 with a disparity of 0.916. On the statement of whether the county government has been able to dully pay outstanding bills on time, facts exhibited that popular participants concurred to a modest level with a mean of 2.961 and a SD of 0.881. On the statement of whether the county has been able to fund its operations, projects and services without incurring deficits, facts exhibited that popular participants concurred at a modest level with a mean of 3.281 and a SD of 0.984. On the statement of whether the county government has been able to meet statutory requirements on expenditure on development activities, facts exhibited that popular participants concurred to a modest level with a mean of 3.372 and a SD of 0.870. On the claim that the county government has been able to pay its debts on when due, facts exhibited that popular participants concurred to abundant level with a mean of 3.433 and a SD of 0.754. These research findings are comparable with those of Otoo and Danquah (2021) who point out local governments in Ghana relied profoundly on the national government to fund their budgets.

Correlation Analysis

The researcher created a correlation matrix between the variables utilizing the SPSS software. The results are summarized in Table 3.

Table 3: Model Summary

		Control environment	Financial performance
Control environment	Pearson Correlation	1	.510**
	Sig.(2-tailed)		.000
	N	231	231
Financial performance	Pearson Correlation	.510**	1
	Sig.(2-tailed)	.000	
	N	231	231

The relationship between control environment and financial performance of County government of Lamu was moderately positive at 0.510 but significant at 0.000 ($p<0.05$).

Regression Analysis

Multiple regressing analysis was computed to derive the relationship between the variables.

Model Summary

Table 4: Model Summary

Model	R	R Squired	Adjusted R Squired	Std Error of the Estimate
1	.637[a]	.405	.392	.52381

a. Predictors: (Constant), Control Environment, Control Activities, Risk Assessment, Monitoring Activities, Information and Communication

Source: Field Data (2023)

The findings from the regression output regarding the model summary results, which are exhibited in Table 4 infer that R square (coefficient of determination) of 0.405 was found which represent 40.5% of the changes in financial performance of County government of Lamu that was explained by changes in internal controls. The rest of the changes, 59.5% were ascribed to the variables outside this model.

Analysis of Variance (ANOVA)

The ANOVA test was done and the results shown in Table 5.

Table 5: ANOVAa

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	42.049	5	8.410	30.651	.000[b]
	Residual	61.735	225	.274		
	Total	103.784	230			

Source: Field Data (2023)

a. Dependent variable: Financial Performance
b. Predictors: (Constant) Control Environment, Control Activities, Risk Assessment, Monitoring Activities, Information and Communication

Given that the $p<0.05$ and the ANOVA results in table 5, it is implied by the value of 0.000 that the regression model was statistically significant and well-fit in forecasting the link between internal controls and the financial performance of the Lamu County government. By utilization of the F test, any F value that is more than one implies significance, thus the F calculated in this case was 30.651 which is more than one and therefore we also draw the conclusion that the model was significant.

Regression Coefficients

The regression output was done and represented in Table 6.

Table 6: Coefficientsa

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	1.186	.186		6.370	.000
	Control environment	.122	.076	.136	1.605	.011

a. Dependent variable: Financial Performance

Source: Field Data (2023)

An OLS was conducted to produce the linking amongst control environment and financial performance of the County Government of Lamu. The following regression equation was established.

Y (Financial performance) = 1.186 + 0.122C_1

The findings show that a unitary rise in control environment would result to 0.122 rise in financial success. A p value of 0.011<0.05) meant that it was both favorable and significant statistically. Accordingly, hypothesis *HO_1* was rejected. This could be attributed the adherence to commitment, competence, integrity and ethical values by county employees. These outcomes support the findings of Omar and Yussuf (2021) who found that the control environment in learning institutions and which entailed commitment, competence, integrity and ethical values of persons performing assigned duties influenced financial performance. It also agreed with Waweru (2021)findings who discovered that the country's public organizations' financial performance was influenced by the control environment, which included the staff's honesty, morals, and competence, the management's operational philosophy, and the delegation of responsibility. It is also consistent with the findings by Omar and Yussuf (2021) who found that the control environment in learning institutions and which entailed commitment, competence, integrity and ethical values of persons performing assigned duties influenced financial performance.

Conclusion and Recommendations

Conclusion

It was concluded that control environment was both statistically significant and favorable and hypothesis one was rejected and the correlation was moderate thus control environment do affect financial performance of County Government of Lamu.

Recommendations

The study recommends that all staff of the County Government of Lamu should show their commitment and competence on their responsibilities and should perform their duties as per laid out standards. It also recommends that all activities and operations in this county should abide by the highest standards of integrity and ethical values among the county employees. It also recommends that specific lines of authority and responsibilities should be put in place to guarantee adherence to the stated policies and procedures.

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