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EFFECTS OF PUBLIC FINANCIAL MANAGEMENT REFORMS ON FINANCIAL PERFORMANCE OF STATE OWNED CORPORATIONS IN KENYA

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Abstract: **The purpose of this study was find out the effects of public finance management reforms on the financial performance of Commercial State-Owned firms in Kenya. The objectives of the study were to determine the effect of the Public Finance Management Reforms on the financial performance of Commercial State-Owned firms in Kenya and to undertake a comprehensive analysis about designing, implementing and assessing public financial management (PFM) reform initiatives amongst Commercial State-Owned firms in Kenya. The study adopted a descriptive survey research design in which samples of 30 out of the 168 commercial state enterprises were targeted. Primary and Secondary data was used in the study. The study used descriptive statistics such as frequency, percentages, mean and standard deviation to show the distribution of responses inferential statistics, regression in particular to show the relationship between the dependent and the independent variables. The study found out that the value of adjusted R square for CSOEs was 0.821, this shows that there were 82.1% changes in the financial performance of the CSOEs after the PMFRs was adopted across the firms. This could be attributed to changes in proper Financial Planning, Effective Internal controls and good management team of the firm. The study found out that only 17.9% was attributable to external factors outside the model. The correlation co-efficient R of 0.994 denotes that there is a strong positive relationship between financial performance and management, financial planning and internal controls. However, there was positive relationship between ROA and training, competence, accounting controls and organizational goals. From the study, the correlation coefficient showed that there was positive relationship between ROE and training, competence, accounting controls and organizational goals. The Pearson's co-efficient matrix among the variables with the focus between the independent variables and the dependent variables. The training of management on adopting the reforms has a weak positive correlation with ROA at 0.371 and is also has a weak positive correlation with ROE at 0.358, this implies that the correlation was less significant at α=0.01. Auditing shows a negative correlation with ROA at -0.242 and at -0.483 for ROE, this implies that the relationship of the coefficient was insignificant at α=0.01 and also shows that most of the cooperatives were not doing effective audits at various organisations levels.**

Keywords: **financial performance, Financial Planning, training, competence, accounting controls.**

1. INTRODUCTION

PFM underlies all government activity. It encompasses the mobilization of revenue; the allocation of these funds to various activities; expenditure; and accounting for spent funds. Public servants will have participated in the steps of the budget cycle when they budgeted for a programme, raised a purchase order, reviewed an expenditure report or prepared documents for external audit scrutiny. Many of the principles of budgeting, expenditure and reporting also hold true for firms and private organizations.

Financial resource is considered as an important resource to many institutions and establishments (Allis, et al, 2007). This means that it must be effectively and efficiently managed to bring about the needed change and results from the activity for which the funds have been made available. However, sometimes this important resource is mismanaged and misappropriated by those put in charge (Rosen & Gayer, 2010). According to Prowle (2010) public sector organizations deal with large amounts of public funds and operate in a largely political environment, thereby necessitating a need for a high degree of confidence in the way in which their financial affairs are being conducted. Furthermore, all other aspects of finance management in the public sector should be done prudently. According to Rosen and Gayer (2010) these feelings towards government are inextricably bound up with its taxing and spending activities.

Financial control is defined as the procedures designed to protect assets and ensure that all financial transactions are recorded to prevent and reduce errors and fraud (Block & Geoffrey, 2008). Financial controls will provide an overall guiding framework for sound and efficient management of resources in all institutions. The goal of having a strong system of financial control will be to promote the institution's ability to reach its objectives, provide reliable financial data, safeguard assets and records, evaluate operational efficiency through budget, organizational control and encourage adherence to prescribed policies and regulations. An institutions' system of financial control will have a key role in the management of risks that are significant to the fulfillment of its operational objectives.

A sound system of financial control will contribute towards safeguarding the stakeholders' investment and the institution's assets. Financial controls will facilitate effectiveness and efficiency of operations, thus help to ensure the reliability of internal and external financial reporting and assist in compliance with laws and regulations (Hayles, 2007). Effective financial controls including the maintenance of proper accounting records help ensure that the institution is not unnecessarily exposed to financial risks and that the financial information is used only within the business (Hayles, 2007). This also contributes to the safeguard of assets, including the prevention and detection of fraud (ACCA, 2010). Obtaining sufficient knowledge of the internal financial controls, both information technology controls and application controls, will be needed to facilitate the determination of the audit strategy and to carry out subsequent steps. According to Khoove (2010) control environment is the attitudes, abilities, awareness and actions of a client personnel and particularly management in relation to control. Financial control activities will be the policies and procedures that will help ensure that management directives are carried out. Control of the financial decisions that will cover the organization, method, process and internal audit established by the administration in order to ensure that the activities are carried out in compliance with the purpose of the administration and determined policies and the legislation, the assets and resources are protected, accounting records are kept in an accurate and complete manner and financial and management information is produced in line and in a reliable manner (Khoove, 2010).

Hence controls of the financial decisions and transactions of the public institutions related to the revenue, expenditure, assets and liabilities concerning their compliance with the budget, budget item, available applicable amount, expenditure programme, financing programme of the administration, to national government budget law and other financial legislation provisions and in terms of the utilization of the resources in an effective, economic and efficient manner (Public Financial Management Act, 2012).

In both the developed and developing countries public financial management professionals working within the public sector are concerned with improving financial management and budgeting, responding to changes in financial reporting, securing better regulation, strengthening institutions and improving management and governance and auditing fraud and corruption. Financial management consists of all the activities concerned with obtaining money and using it effectively and efficiently (Warren, 2007). Financial management will involve careful planning and efficient use of resources. Proper financial management will ensure that financial priorities are established in line with organizational goals and objectives, spending will be planned and controlled in accordance with established priorities and sufficient financing available when it is needed both now and in the future (Pride et al., 2007). It is generally recognized that most developing countries have ineffective governmental financial control system. The serious deficiency in the financial control systems in most developing countries is generally recognized as the major factor which facilitate the misuse of public resources and financial corruption in these countries (El- Nafali, 2008). Kenya is considered to have the largest, most diversified and innovative economy in East Africa (Karanja&Ng'ang'a, 2014). The country will have the potential to reduce poverty and increase job opportunities not only to its citizenry but also to other countries within East Africa and beyond. Kenya has made significant strides in improving the overall economic environment with a performance always above that of the Sub-Saharan Africa (SSA) average Country Policy & Institutional Assessment (CPIA) Reports, 2006-2012.

Public Financial Management Reforms:

The last decade has seen the Kenya Government initiate a number of Public Financial Management Reforms (PFMR) in order to enhance accountability and transparency in its public finance systems. The targeted institutions include budget formulation, public procurement, external audit, revenue collection, budget execution, internal audit, parliamentary oversight, payroll and pensions, debt and guarantee, external resources, accounting and reporting and the macro-fiscal framework.

Financial management reforms are defined as the developments and changes overtime in the field of finance. They explain that by the mid -1950s finance moved away from its descriptive and definitional nature and became more analytical. One of the major advances was the decision-oriented process of allocating financial capital (money) for the purchase of real capital (Long term plant and equipment). Modern financial management has focused on risk – return relationships and the maximization of return for a given level of return (Block, Hirt & Danielson, 1978).

Financial management reforms further mean improvements or amendments on the management of spending, revenues, taxation, borrowing, debts, foreign reserves, foreign exchange system, level of liquidity in the economy and finance auditing in order to achieve some stated objectives by Institute of economic affairs (2002). Financial management reforms are important in that they lead to prudent allocation of financial capital for the purchase of real capital. It further enables reorganization of financially troubled organizations. The reforms lead to optimal management of cash, inventory and development of appropriate dividends policies (Block et al. 1978). The reforms assist in dealing with fiscal crisis, public pressure, donor pressure, political change including post-

Conflict situations and the demands of regional affiliations. Strong Public Financial management systems are essential to improved service delivery, poverty reduction and to achievement of the Millennium Development Goals. Effective PFM systems maximize financial efficiency improve transparency and accountability, and in theory – will contribute to long-term economic success (Pretorius & Pretorius, 2008).

Financial management reforms are measured through various methods which includes measurement through budgetary reforms which help in risk management. Accounting reforms are also used as a measure they could entails moving from manual systems to the use of internets. Use of internet led to the internet craze of the 1990s that resulted to the "new economy' (Block et al., 1978). Implementations of audit recommendations and paradigm shifts of the audit practices are a critical part of the financial reforms measurement. Auditing provides budget oversight and controls (Pretorius et al., 2008). In addition, monitoring and evaluation has been used to measure the performance of these reforms coupled with observation and experience.

Commercial state owned firms:

These are legal entities that are created by the government in order to partake in commercial activities on the government's behalf. A state-owned enterprise can be either wholly or partially owned by a government and is typically earmarked to participate in commercial activities. The defining characteristics are that they have a distinct legal form and they are established to operate in commercial affairs. While they may also have public policy objectives, Commercial State Owned Enterprises should be differentiated from other forms of government agencies or state entities established to pursue purely non-financial objectives .Government-owned corporations on the other hand are common with natural monopolies and infrastructure such as railways and telecommunications, strategic goods and services (mail, weapons), natural resources and energy, politically sensitive business, broadcasting, demerit goods (alcohol) and merit goods (healthcare) WiseGeek (2013).

Statement of the Problem:

In the recent past, the Kenyan government had undertaken several initiatives to improve Public Finance Management in Commercial State Owned Firms. First and foremost of all, the role of Parliament and the Audit General had previously been ignored hence necessitating for several reviews of the PFM reforms in Kenya to be conducted since 2006, and these reviews have over the last four years been revealed that there is still a number of challenges facing this cooperation .According to the Kenya Revenue Authority Fourth Quarter Revenue Performance Report 2011/12 as at the end of June 2012, cumulative revenue receipts in the country amounted to Kshs 707.4 billion, against a targeted Kshs 717 billion. This reflected a performance of 98.7%. The underperformance was mainly due to Government incentives like exemptions, remissions and tax reductions coupled with weak enforcement mechanisms (PFMR Strategy, 2013)

A number of studies have also been undertaken locally and internationally on the subject area of Public Finance. For instance, the World Bank Report on Public Financial Management Reforms (2012) stated that there was still a lot to be done to improve budgeting and public financial management (PFM) in Africa including Kenya; mainly emphasizing that critical challenges to good PFMR in Africa since most reforms implemented are clustered around the budget formulation stage, while reforms at the other stages of the budget process particularly budget execution and auditing lag behind. This is a common incidence for many Commercial State Owned Enterprises in Kenya during their budgeting process. The PFMR Strategy Assessment Memorandum in May 2006 set out an assessment of the Government of Kenya Strategy for Reform of Public Financial Management (the PFMR strategy) prepared by the PFM Reform Coordinating Unit and the Ministry of Finance. The Assessment Memorandum concluded that Kenya lacks a tactical and operational strategy relating to Public Finance subbed by the fact that the Ministry of Finance is facing several constraints and challenges. In addition, the existence of interest groups with conflicting interests and bargaining powers have also played a role (Mars groupKenya, 2006). In addition, a study by the Business Daily Africa, (2013) also reported that government accountants have been put on notice for failing to keep proper financial records, a clear indication in the slack by the Public Finance Management Act 2012. The Auditor General said that this had led to a situation where the government has no credible records of its assets or debts. This worrying state of affairs is captured in the Auditor General's report presented before the Public Accounts Committee (PAC). Various ledgers and trial balances for 2010/2011 against which the financial statements are drawn were incomplete, missing or full of errors. As a result, out of the 173 financial statements audited, only 29 per cent were certified, meaning the auditors were able to form an opinion, while the remaining 71 per cent were rejected.

As per the aforementioned studies from various sources, there is a clear indication that there exists a gap in the management of public funds in the country, with special focus being on Commercial State Owned Enterprises in Kenya. This therefore leads to my research question: What is the impact of Public Finance Management Reforms on financial performance of Commercial State Owned Firms in Kenya?

Objectives of the Study:

To assess effect of Public Financial Management Reforms on the Financial performance of State owned firms.

Research Hypothesis:

$\mathbf{H_0}$ There is no significant relationship of public financial management reforms on financial performance of state owned firms

$\mathbf{H_1}$ There is a significant relationship of public financial management reforms on financial performance of state owned firms

2. LITERATURE FRAMEWORK

Theoretical Framework:

The Agency Theory:

Agency theory will describe firms as necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behavior of agents. The theory will recognize the incomplete information about the relationship, interests or work performance of the agent described as adverse selection and moral hazard (Laudon 2007). Moral hazard and adverse selection affects the output of the agent in two ways; not doing exactly what the agent is appointed to do, and not possessing the requisite knowledge about what should be done. This affects the overall performance of the relationship as well as the benefits of the principal in the form of cash residual. Other related reviews include The Sarbanes-Oxley Act of 2002 (SOX) which requires companies to report on the effectiveness of their internal controls over financial reporting as part of an overall effort to reduce fraud and restore integrity in the financial reporting process. It is further asserted that software vendors that market Enterprise Resource Planning (ERP) systems have taken advantage of this new focus on internal controls by emphasizing that a key feature of ERP systems is the use of "built-in" controls that mirror a firm's infrastructure (Morris, 2011).

Financial control is one of many mechanisms used in business to address the agency problem. Others include financial reporting, budgeting, audit committees, and external audits. Studies have shown that internal control reduces agency costs with some even arguing that firms have an economic incentive to report on internal control, even without the requirements of SOX. It is also argued that providing this additional information to the principal (shareholder) about the behavior of the agent (management) may reduce the information asymmetry and lower investor risk and, therefore, the cost of equity

capital. Other research has found that weaknesses in internal controls are associated with increased levels of earnings management (Chan et al., 2008; Alsbaugh et al., 2008). Earnings management is the agency problem that motivated SOX legislation in the first place, specifically earnings manipulation by Enron, WorldCom. Financial controls have played a major role in moderating the agency problem in corporations for many years. During the 1980s, several high-profile audit failures led to creation of the Committee of Sponsoring Organizations of the Tredway Commission (COSO), organized for the purpose of redefining internal control and the criteria for determining the effectiveness of an internal control system (Simmons, 2007). The product of their work is known as the COSO Internal Control-Integrated Framework (Simmons, 2007). The framework will also point out that controls are most effective when they are "built into" the entity's infrastructure (COSO, 2007) and will further state that "built in controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions. The COSO framework plays a key role in compliance because Section 404 of the Act requires companies to include in their annual report, a separate management report on the company's internal control over financial reporting and an attestation report issued by a registered public accounting firm. Morris (2011) separates financial controls into those that are general (entity-wide) controls from those that are specific (account-level) controls. He believes that if management was overriding control features in order to manage earnings, then one would expect to find more financial control weaknesses related to general controls, even if the specific (account-level) controls are effective. This type of behavior should be uncovered during the audit process since this is an area of concern specifically identified in Auditing Standard No. 5, Paragraph 24, which states that "entity-level controls include controls over management override." On the other hand, a stronger argument could be made that if general controls are in place and working, then one would expect to find less Internal Control Weaknesses related to general controls. Internal controls have been incorporated into policies, rules and regulations to help organizations achieve their established objectives. This is because internal controls are meant to help an organization achieve its objectives. The COSO commission was partly instituted in response to a series of high profile scandals and business failures where stakeholders (particularly investors) suffered tremendous losses.

Theory of Financial Control:

The present and future personal functions of human beings are asserted to constitute the fundamental point of reference in a theory of financial controls. This theory stipulates that existing and possible functions of financial tools for organizations are most essential. In the same light, it is stated that, payments, financial instruments, accounting, control models, economic calculations, and related considerations, both within and outside of the organization, ought to be discussed in regard to inner characteristics but also possible effects. It is noted that establishing the relationships between various activities and financial processes, from a financial control point of view, is a general and basic issue (Osman, 2009). The theory of financial controls for organizations places a natural focus on the firms such that they are viewed from several latitudinal areas. The first regards the human beings' functions of what is accomplished through organizations, their activities and output. The second is about the structure of the organization and activities, and of transactions that various parties have with each other. The third area covers the control systems in the sense of recurring procedures and methods that are employed to relate present and future functions to resources both externally and internally. The aforementioned financial control tools are argued to be crucial from an individual organization's perspective and also for larger economic systems. The fourth and last area illustrates the specific processes of individual organizations for certain issues. The theory further states that structure and financial control system works together (Osman, 2009).

The financial control theory is very relevant to the current study given that it assists in better understanding of the intricacies surrounding financial management in an organization.

3. RESEARCH METHODOLOGY

This section sought to describe the research design. Research methodology was used in the current study to guide the research on the identified study variables. Against the backdrop of its importance, Industrial Research Institute (2010) indicated that research methodology helps the research to scientifically discover all the conceivable answers of given research queries to their logical conclusion.

Research Design:

Research design is a framework for collecting valid and reliable data to test the hypotheses or answer the research questions. Hence, research design concerns the more fundamental question of how the study subjects will be brought into the scope of the research and how they will be employed within the research setting to yield the required data (Abdellah

and Levine, 1979:166). The researcher will use descriptive and survey designs in this study. The descriptive design was applied to facilitate the research to identify the present performance of state owned firm's reforms of public financial management regarding effective and judicious use of public financial resources. While the survey design will be used to collect the primary data representing a cross-section of the target population of all state owned entities. The research used secondary data. Zikmund et al, (2007) defines secondary data as the data that had previously been collected for some purpose other than the one at hand. On the other hand, a descriptive research describes the characteristics of objects, people, groups, organizations etc. It addresses the what, why, who, when, where and how questions. Therefore, the descriptive survey was the method that was used to collect data from the population and help the research to get the process of collecting data in order to answer question regarding the current status of the subjects in the study. Thus descriptive survey was an appropriate as it sought to ascertain thefinancial performance of Commercial State Owned Enterprises with relation to the PFMR.

4. RESULTS AND DISCUSSION

Impact of PFM Reforms on the Financial Performance:

The respondents were asked to state the extent to which the implementation of PFM reforms had enhanced the financial performance of the organizations. This was on a scale of not at all, little extent, moderate extent, great extent and very great extent. The score 0.0 to 1.0 represent not at all, the score 1.1 to 2.0 represent little extent, the score 2.1 to 3.0 represent moderate extent, the score 3.1 to 4.0 represents great extent and the score 4.1 to 5.0 represent to very great extent. The study findings presented in Table 4.1 show that the respondents indicated that the credibility of the organizations budgets influenced the financial performance of the organization to a great extent (mean score 3.47). The findings further show that according to respondents, the comprehensiveness and transparency of the budget impacted the financial performance of the organization to a great extent (mean score 3.27). The results also show that the respondents indicated that the predictability and control in budget execution impacted the financial performance of the organization to a great extent (mean score 3.69). The results revealed that according to the respondents, the external scrutiny and audit influenced the financial performance of the organization to a great extent (mean score 3.42). The respondents further stated that the policy based budgeting in the organization influenced the financial performance of the organization to a very great extent (mean score 4.789).

From the study findings, respondents indicate that both the accounting, recording and reporting and donor practices impacted the financial performance of the organization to a great extent (mean scores 3.96 and 3.57 respectively).

The findings show that there were no variances in the responses (standard deviation ≤ 1) except to external security and audit and donor practices (standard deviation ≥ 1). These findings mean that the implementation of PFM reforms have a direct effect of the financial performance of the organization.

Table 1: Impact of PFM Reforms on the Financial Performance

	N	Mean	Std. Deviation
Credibilityofyour organizations budget	57	3.47	.902
Comprehensiveness and transparencyof thebudget	57	3.27	.884
Predictabilityandcontrol in budget execution	57	3.69	.992
External scrutinyandaudit	57	3.42	1.206
Policybased budgeting	57	4.789	.653
Accounting, recordingand reporting	57	3.96	.766
Donor practices	57	3.57	1.140

Regression Analysis:

A multiple linear regression was done to determine the relationship between financial performance and all the independent variables i.e management, financial planning and internal controls

Table 2; Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.943[a]	.889	.821	0.107684

a. Predictors: (Constant), Fp,Ic,Mgt

The value of adjusted R square for CSOEs was 0.821, this shows that there was 82.1% changes in the financial performance of the CSOEs after the PMFRs was adopted across the firms. This could be attributed to changes in proper Financial Planning, Effective Internal controls and good management team of the firm. The study found out that only 17.9% was attributable to external factors outside the model. The correlation co-efficient R of 0.994 denotes that there is a strong positive relationship between financial performance and management, financial planning and internal controls.

Regression Coefficient after Implementation of PFMR:

Table 3: ROE Regression Coefficient after Implementation of PMFR

Coefficients[a]				
Model		Unstandardized Coefficients		Standardized Coefficients
		B	Std. Error	Beta
1	(Constant)	-1.839	.000	
	management	0.323	.000	.169
	Financial Planning	0.116	.000	-.102
	Internal Controls	0.597	.000	-.998
a. Dependent Variable: ROE				

ROE= $\beta o + \beta_1 (Mgt) + \beta_2 (Fp) + \beta_3 (Ic) + \varepsilon$**……………………………………………ii**

$Y=1.839+0.323X_1+0.116X_2+0.597X_3$

From the above regression model, if Management, Financial planning and Internal control of the state owned firm approaches a constant of zero. The financial performance of state owned firms would be 1.839. It's established that a unit increase in management involvement and effective initiative to implement PFMR would cause an increase in the financial performance of the state owned firms firm by a factor of 0.323, a unit increase as a result of adequate financial planning of the state owned firms would result to an increase in financial performance of the state owned firms firm by 0.116, further a unit increase as a result of effective adequate internal controls would result to an increase in financial performance of the state owned firms firm by a factor 0.597.This is an indication that financial performance of the state owned firms firm was positively associated with proper management , adequate financial planning and effective internal controls of the firm. The study further indicates that the P-value was less than 0.05 in all the variables, which showed that all the independent variables were statistically significant and thus in position to make conclusion for the study.

5. CONCLUSION

As clearly shown in the study findings, all the state corporations in the study had adopted the public finance management reforms in accordance with the Public Finance Management Act 2012 which required all the government agencies including the commercial state corporations adopt the reforms in their management of public finance, the study concludes that all the state corporations have been compliant with the reforms process that have been initiated by the government aimed at improving the management of the public finance which have for a long time been wasteful. The study also concludes that there was a positive change in financial performance of commercial state-owned enterprises in Kenya which was attributed to the public finance management reforms.The study further concludes that for a number of these public enterprises, the effectiveness and sustainability once initial performance indicators have been achieved will be dependent on a continuing commitment to recurrent costs. These were achieved through proper financial planning, effective management and efficient internal controls were well used which according to the findings of the study positively influenced the financial performance of the enterprises. The proper accounting controls put by the management eliminated the wastages in the expenditure of the public finance through proper management and accountability and ensured proper and prudent allocation of the public resources. The study also concludes that through the public

management reforms, the government has been able to improve the accountability of the donor funds through the PFM cluster scores. Through the accountability the government is able to attract more funds from the local and international donors as more investors are willing to bring in their resources for investment knowing that the likelihood to gain from their investment is high. Hence more public funds for investment in key areas of the country such as education, infrastructure, health and security and improved service delivery to the publics. All these are attributable to the adoption of the public finance reforms in the state corporations.

6. RECOMMENDATION

The study established that the PFM reforms have enhanced the financial performance of the commercial state enterprises as such vices as corruption, outright mismanagement of public funds among others have been minimized if not eliminated. The study recommends that the government should expand the implementation in PFM reforms in other state corporation and all the government agencies so as to enhance their financial performance especially in the public offices where outright mismanagement of public funds .The study established that the effect of some variables such as comprehensiveness and transparency in the budget and external scrutiny and audit did not have a strong influence on the financial performance of the organization despite showing potential and despite earlier studies showing a positive influence. The study recommends that the government should strengthen these factors with the view of enhancing their effectiveness in the public finance management process so as to achieve improves financial performance of these commercial state corporations and other government agencies. The study also established that such factors as credibility of the budgets, policy based budgets and donor practices had insignificant influence on the financial performance of the corporations despite being touted as having ability to turn around the financial performance of the public corporations. The study recommends that the government through its various departments should strengthen such factors as credibility of the budget, policy based budget and donor practices for sustainability of the profitability of the organizations which have otherwise experienced poor financial performance but have the potential of registering higher profits if prudently managed.

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