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EFFECT OF EXTERNAL AUDIT OUTCOMES ON FINANCIAL PERFORMANCE OF COUNTY GOVERNMENT OF NAKURU, KENYA

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Abstract

The County Government of Nakuru has been facing diverse financial performance related challenges. These challenges include under collection in the local revenue for the 2014/2015 by 24% due to county government failure to update valuation, and overspending on the employees' wages and remuneration with expenditure amongst other aspects. The objective of this study was to determine the effect of external audit outcomes on financial performance of county governments with a focus on Nakuru County. The study adopted a descriptive survey research design where senior and middle level management staffs in the finance department were targeted. 80 employees in the County Government of Nakuru were sampled through the census method. Structured questionnaires were used for data collection and their validity checked using content validity index, while Cronbach alpha coefficient of 0.7 was established as the reliability test. The study used frequencies as descriptive statistics while the Fisher's exact test, correlation analysis and regression analysis were used as the inferential statistics to examine the relationship between external audits outcomes and financial performance of County Government of Nakuru. The study found that external audit outcomes positively influence the financial performance of County government of Nakuru. The study thus recommended that the finance department of the County Government of Nakuru continually provide training to its officials to ensure that best practices in audit are embraced. The department should also encourage implementation of good financial management systems including internal control systems so that there are well maintained records and accounts which are readily available when information and explanations by external auditors are requested.

Keywords: *Enforcement Capacity, External Audits, External Audit Outcomes, Financial Performance*

I.INTRODUCTION

The function of the governments is service provision to its citizens. In this context, the purpose of devolved government structures such as local governments, municipalities and county governments is enhance service delivery to the citizens. In this context, the devolved governments often receive financial support from the central government as well as generate their own financial resources through taxation and levying diverse charges for services provided (Wakaba, 2014). The financial performance of the devolved governments such as county governments, municipalities, and other local governments is of importance to the tax payers. This is due to the necessity for accountability in financial management aspects of county governments to ensure that collected funds are used prudently, presence of value for money in public funds expenditure and enhanced service delivery aspects.

The financial performance of county governments is often different from those of commercial entities. According to Isaboke (2016) aspects of financial performance within county governments include improvement in revenue collection, infrastructural investment, efficient resources allocation, and effective budgetary allocation. Mohamed (2017) further indicates that financial performance within the context of county governments involves diverse components. These components include revenue collection, effective utilization of public resources, and management of public debts. The collection of revenues during and immediately after the audit can be used as measure for the effect of audits on financial performance. The financial performance in diverse devolved governments such as county governments are often challenged by corruption, misuse of financial resources, and lack of value in procurement aspects amongst other financial performance challenges. In this context, the external audits may be required to enhance the financial performance of the devolved governments. The external audits relates to the independent examination of the county governments financial affairs and books with a view of determining that the financial records are a true reflection of the financial state of the county.

Diverse aspects of external audits have been found to have diverse influence on the financial performance of organizations. Alzeban & Sawan (2013) noted that amongst the staff attitudes that influenced financial performance include negative attitudes towards audit activities amongst management staff, and lack of information on the importance of the auditing. Kwaza (2017) noted that amongst the external audit queries closure aspects that influenced financial performance included conceptualization of audit action plans, addressing the issues raised by the auditor general reports on a periodic basis and addressing the root cause of the previous year's audit findings.

The capacity to enforce the audit recommendations has significant influence on financial performance aspects. In this context, Kwaza (2017) noted that audit recommendations being monitored until they are fully implemented has positive influence on financial performance. Utumi (2016) further noted internal auditors should have the capacity to monitor and follow up with internal and external audit recommendations. Korje (2016) noted that diverse aspects may influence the organization's capacity to enforce audit reports including lack of competency of human resources, poor supervision and control aspects of public institutions, poor quality of services in the institutions, inadequate internal control measures and lack insufficient budget to implement the audit recommendations.

The external audit outcome has an influence on the financial performance aspects. Mamogale (2014) noted that amongst the audit outcomes with influence on financial performance include clean audit findings, financially unqualified findings, and audit outcomes with disclaimer of opinions. Kruger & Rooyen (2016) noted that enhanced oversight aspects and timely responding to financial issues has an influence on the audit outcomes aspects. Kasiva (2012) noted that audit queries were acted upon in a timely manner was a critical component of financial performance.

The county governments in Kenya have been given diverse financial management requirements that are critical indicators of the financial performance. According to Government of the Republic of Kenya (2012), the public finance management act of 2012 places diverse financial performance indicators for the county government. Section 107 of the public finance management act of 2012 spells out the fiscal responsibilities of the county government as follows; recurrent expenditure shouldn't exceed the county government's total revenue and thirty percent of the county government budget should be allocated to development expenditure (Government of the Republic of Kenya, 2012). Other aspects include the county government expenditure on wages not to exceed the set limit by the county executive for finance, government borrowing to be utilized for development budget and maintaining a predictable tax regimes (Government of the Republic of Kenya, 2012).

The external audit is often performed within organizations and county governments with a view of enhancing the financial performance of those organizations. According to Nyabiosi, (2016) external audit refers to an independent examination of the financial statements prepared by the organization mostly due to the statutory purposes. On the other hand, (Government of Kenya, 2003) indicates that the external audit as applies to the county governments in Kenya involves the performing of procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The county governments of Kenya are supposed to be audited by an external independent auditor from the office of the auditor general.

According to Office of the Auditor General, (2015), external audits should be conducted on the county governments financial statements based on the section 9 of the public audit act of 2003 and a report submitted in compliance with article 229(7) of the constitution. Based on the provisions of section 8 and 9 of the public audit act of 2003, the auditor general in conducting the external audits have four broad mandates; indicating on whether all required information and explanations for audits were received, checking that proper records of all transactions were maintained, checking that the accounts are in agreement with the maintained records and certifying that the accounts reflect the true financial position of the audited entity (Government of Kenya, 2003).

II.RESEARCH OBJECTIVES

(i) To examine the effect of external audit outcomes on financial performance of County Government of Nakuru, Kenya.

III.RESEARCH HYPOTHESES

The study tested the following hypotheses:

(i) **H_{01}:** There is no statistically significant influence of external audit outcomes on financial performance of County Government of Nakuru, Kenya.

IV. LITERATURE REVIEW

Audit Lending Credibility Theory

Lending credibility theory was developed by Limperg in the year 1920 to inspire confidence in financial statements of an organization. The theory states that the primary function of the audit is to add credibility to the financial statements. The theory assumes that confidence in financial statements is increased upon relying on audited financial statements rather than the unaudited financial statements presented by the management team of the organization. As explained by the Lending credibility theory, in order to satisfy organizations' stakeholders, the financial statements have to be audited (Kruger & Rooyen, 2016). The stakeholders who are the users of the financial statements to make decision in regard to the activities of the organization, gain benefits from the increased credibility of financial statements. The benefits may be in terms of the quality of investment decisions improve when they are based on reliable information, enhanced principal gent's relationship and reduction of information asymmetry (Mamogale, 2014).

In the context of external auditing, county governments relay on audited financial records in order to make decisions on the developments projects to undertake. Stakeholders such as suppliers and contractors to county government's projects heavily rely on the audited financial reports in order to have faith in the county governments operations. The outcomes of the audited financial reports are very crucial to the residents of the county in establishing how their county government is performing in regard to its operations and management of resources. The outcomes of the external audit therefore determine the confidence of the citizens and other stakeholders on the financial performance of the county government (Mwangi, 2014). Therefore, the Lending credibility theory guided the study to examine the effect of external audit outcomes on financial performance of County Government of Nakuru, Kenya.

External Audit Outcomes and Financial Performance

The role of the external audit outcomes on the financial performance has been examined by diverse scholars. In south Africa, Mamogale (2014) undertook a study that sought to examine the influence of financial performance of local governments within Limpopo province for the 2009/2010 and 2010/2011 financial years. The study utilized secondary data from the auditor general reports and qualitative means of data analysis. The study found that the municipalities with clean audits were 1 and 2 for the 2009/2010 and 2010/2011 financial years respectively. The study further found that the municipalities within Limpopo regions with their audit outcomes as financially unqualified with findings stood at eight municipalities and three municipalities for the 2009/2010 and 2010/2011 financial years respectively. Finally, the study also found that the audit outcomes with disclaimer of opinions stood at nine municipalities and seven municipalities for the 2009/2010 and 2010/2011 financial years respectively. The study attributed the clean audit reports for two municipalities with the recruitment of young and well educated financial officers who have implemented good financial management systems including internal control systems. Mamogale (2014) study was based in South Africa and utilized secondary data from auditor general to examine the financial performance in the local municipalities. This study is based on the county government in Kenya and thus different from Mamogale study.

In a study focusing on free state province of south Africa, Kruger & Rooyen (2016) sought to examine the role of municipal audit outcomes on the performance of the municipal governments. To achieve its objectives the study utilized secondary data collection from the auditor general reports and focused on the 2013/2014 financial year. The study found that five auditees had improved from qualified to unqualified audit opinions with findings. This was attributed to enhanced oversight aspects and timely responding to financial issues. On the other hand, three municipalities had improved from disclaimer to unqualified audit opinions.

Focusing on commercial state corporations in Kenya, Mwangi (2014) examined how risk based audit affects the financial performance of the corporations. The study sampled the chief internal auditors in the state corporations in Kenya. To collect its data, the study used both primary and secondary sources of data. Primary data was collected through structured questionnaires while secondary data was obtained from financial reports for the state corporations. Using five point Likert scale where: 1–Very low extent 2–Low extent 3–Moderate extent 4-Great extent and 5-Very great extent, the study established that state corporations on average acted on reported audit queries in a timely manner as indicated by a mean of 4.475 and a standard deviation of 0.2671. Mwangi (2014) study was based on commercial entities while the current study is based on the county governments.

V.RESEARCH METHODOLOGY

The study adopted a descriptive survey research design where senior and middle level management staffs in the finance department were targeted. It sampled 80 employees in the County Government of Nakuru through a census method. Structured questionnaires were used for data collection and their validity checked using content validity index, while Cronbach alpha coefficient of 0.7 was computed as a test of their reliability. The study used frequencies for descriptive statistics. Also, the inferential statistics such as the Fisher's exact test, correlation analysis and regression analysis were used to examine the relationship between external audits aspects and financial performance of County Government of Nakuru.

VI.RESEARCH FINDINGS AND DISCUSSIONS

Inferential External Audit Outcomes and Financial Performance

The study examined the effect of external audit outcomes on financial performance of County Government of Nakuru, Kenya by looking at the aspects of timeliness, relevance of audit outcomes, and documentation. The results of respondents' rating on the extent of agreement with various statements related to these three indicators are displayed in Table 1. A majority of respondents (46.5%) tended to agree to a large extent that the external audit reports of County Government of Nakuru are issued in timely manner. About a quarter of the respondents (25.4%) tended to agree with the statement to a moderate extent while 14.1% and 8.5% tended to agree to a small extent and very large extent, respectively.

Table 1: Frequencies, Fisher's Exact Value, and p-value for External Audit Outcomes

	NE	SE	ME	LE	VLE	Fishers Test	Exact
	%	%	%	%	%	Value	P
The external audit reports are issued in timely manner	5.6	14.1	25.4	46.5	8.5	19.970	0.024
The external auditors give realistic recommendations through the audit reports	2.8	15.5	46.5	28.2	7.0	27.578	0.000
External audit reports are accompanied by relevant documents	4.2	12.7	23.9	45.1	14.1	20.981	0.009
The audit reports provide solutions to queries raised	7.0	11.3	29.6	39.4	12.7	25.297	0.000
The external audit reports contain qualified audit opinions	1.4	16.9	46.5	32.4	2.8	28.583	0.000

However, 5.6% of the respondents tended to disagree and indicated that to no extent are external audit reports issued in timely manner. The study results of the Fisher's exact test revealed timeliness in issuing of external audit reports and financial performance of the County Government of Nakuru, Kenya are related (Fishers exact value=19.970; p-value<0.05).

A majority of respondents (46.5%) tended to agree to a moderate extent that external auditors give realistic recommendations through the audit reports. About a quarter of the respondents (28.2%) tended to agree with the statement to a large extent. Other respondents who tended to agree with the statement were 15.5% to a small extent and 7.0% to a very large extent. On the other hand, 2.8% of the respondents tended to disagree and indicated that external auditors do not give realistic recommendations through the audit reports. The study established that a relationship exists between the realistic nature of recommendations given by external auditors through the audit reports and financial performance of the County Government of Nakuru, Kenya due to a Fisher's exact value of 27.578 and a p-value of 0.000 (p<0.05).

In the context of documentation, most of the respondents tended to agree (45.1%) to a large extent that external audit reports are accompanied by relevant documents followed by 23.9% who perceived the extent as moderate, 14.1% who perceived the extent as very large, and 12.7% who perceived the extent as small. A few respondents (4.2%) tended to disagree and indicated that external audit reports are not accompanied by relevant documents. When a

Fisher's exact test was conducted in respect to this statement, the Fishers exact value generated was 20.981 and a p-value of 0.000($p<0.005$). These results therefore revealed that there exists a relationship between external audit reports accompaniment by relevant documents and financial performance of the County Government of Nakuru, Kenya.

A majority of respondents (39.4%) tended to agree to a large extent that the audit reports of the County Government of Nakuru provide solutions to queries raised. Other respondents in agreement with the statement were 29.6% who agreed to a moderate extent, 12.7% who agreed to a very large extent, and 11.3% who agreed to a small extent. On the other hand, 7.0% of the respondents tended to disagree (chose "No Extent" prompt) with the statement and indicated that the audit reports of the County Government of Nakuru do not provide solutions to queries raised. A Fisher's exact value of 25.297 and p-value of 0.000 ($p<0.05$) revealed that a relationship exists between audit reports provision of solutions to queries raised and financial performance of the County Government of Nakuru, Kenya.

Almost half of the respondents (46.5%) tended to agree to a moderate extent that the external audit reports of the County Government of Nakuru contain qualified audit opinions. In addition, some respondents tended to agree to a large extent (32.4%), small extent (16.9%), and very large extent (2.8%) that the external audit reports of the County Government of Nakuru contain qualified audit opinions. However, a negligible 1.4% of the respondents indicated that the external audit reports of the County Government of Nakuru do not contain qualified audit opinions. The qualified audit opinions being contained in external audit reports and financial performance of the County Government of Nakuru, Kenya are related as (Fishers exact value=28.583; $p<0.05$).

Regression Analysis

The study used multiple linear regression to establish the effect of staff attitude towards external audit, external Audit Outcomes, Audit Queries Closure and Enforcement Capacity external audit recommendations on the financial performance of County Government of Nakuru. Table 2 shows the model summary of the regression model.

Table 2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.916[a]	0.839	0.829	0.22250

Predictors: (Constant), Staff Attitude, Audit Outcomes, Audit Queries Closure, Enforcement Capacity

The model summary gives an R value of 0.916 and R-square value of 0.839. An adjusted R Square value of 0.829 and standard error of estimate of 0.22250 were also obtained. The R is the correction coefficient between the observed and predicted values of the dependent variable and it indicates the goodness of fit of the regression model to the data (Saunder, Lews, & Thornhill, 2009). Therefore, there was a strong relationship between the observed and predicted values of the financial performance of County Government of Nakuru. This implies that the model provides a good fit for the data. R-Square is called the coefficient of determination and shows the proportion of variation in dependent variable that is attributable to the independent variables in the study (Keller, 2014). This therefore implies that 83.9% of the variation in the financial performance of County Government of Nakuru is cumulatively attributable to staff attitude towards external audit, external Audit Outcomes, Audit Queries Closure and Enforcement Capacity external audit recommendations. In this regard, 16.1% of the variation in the financial performance of County Government of Nakuru is attributable to other factors that were not studied by the current study.

Adjusted R-Squared shows the effect of adding more predictor variable into the regression equation. It gives the portion of variability in the dependent variable as explained by significant predictors only (Jankowicz, 2005). In this regression model, 82.9% of the variability in financial performance of County Government of Nakuru is attributable to staff attitude towards external audit, external Audit Outcomes, Audit Queries Closure and Enforcement Capacity external audit recommendations without the constant value which was found to be statistically insignificant ($p>0.05$). Standard error of estimate shows the accuracy of the prediction model (Sekaran & Bougie, 2011). A low standard estimate of error of 0.22250 obtained in this regression model indicates that the multiple regression model is accurate in its prediction of financial performance of County Government of Nakuru. The study further sought to establish whether the regression model is significant predictor of the dependent variable as shown in Table 3.

Table 3: ANOVA[a]

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	17.055	4	4.264	86.128	.000[b]
Residual	3.267	66	.050		
Total	20.322	70			

a. Dependent Variable: Financial Performance
b. Predictors: (Constant), Staff Attitude, Audit Outcomes, Audit Queries Closure, Enforcement Capacity

The F-value in the analysis of variance indicates that significance of the regression model as a whole. The null hypothesis of the F-test in the regression model states that the multiple linear regression model has no predictive capacity better than a regression model that consists of zero predictor variables (Saunder et al., 2009). The regression model in this study obtained an F-statistic value of 86.128 with 4 degrees of freedom for the regression and 66 degrees of freedom for residual. This test was found to be statistically significant at 5% significant level ($p<0.05$). This implies that the regression model had a statistically significant predictive capacity more than a regression model that contains zero predictor variables. Therefore the regression model can significantly predict financial performance of County Government of Nakuru using staff attitude towards external audit, external audit outcomes, audit queries closure and enforcement capacity external audit recommendations as predictor variables. The study further sought to establish the effect of each of the predictor variable on the financial performance of County Government of Nakuru as shown in Table 4.

Table 4: Model Coefficients[a]

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.168	0.202		0.830	0.409
Staff Attitude	0.253	0.063	0.262	3.994	0.000
Audit Outcomes	0.199	0.059	0.102	3.684	0.007
Audit Queries Closure	0.361	0.062	0.410	5.826	0.000
Enforcement Capacity	0.252	0.052	0.332	4.853	0.000

a. Dependent Variable: Financial Performance

The unstandardized beta coefficients show the extent in which the independent variables affect the dependent variable in the study (Saunder et al., 2009). Unstandardized beta coefficient of 0.199 was obtained in regard to Audit Outcomes. This implies that a unit increase in audit outcomes will result into 0.199 units increase in financial performance of County Government of Nakuru. This influence was found to be statistically significant due to t-statistic values greater than the critical value and p-values less than the significance level of 0.05 chosen for this study. This was the basis for hypothesis testing.The study hypothesis stated that there is no statistically significant influence of external audit outcomes on financial performance of County Government of Nakuru. This hypothesis was rejected due to t-statistic value (3.684) greater than the critical value and p-value less than 0.05. It was therefore concluded that there was a significant influence of external audit outcomes on financial performance of County Government of Nakuru, Kenya.

VII.CONCLUSION OF THE STUDY

The study examined the effect of external audit outcomes on financial performance of County Government of Nakuru by looking at the aspects of timeliness, relevance of audit outcomes, and documentation.The results of the Fisher's exact test revealed that timeliness in issuing of external audit reports and financial performance of the County Government of Nakuru, are related. In the context of documentation, the study found that a relationship exists between external audit reports accompaniment by relevant documents and financial performance of the County Government of Nakuru. In regards to relevance of audit outcomes, the study established that the realistic nature of recommendations given by external auditors through the audit reports, audit reports provision of solutions to queries raised, and qualified audit opinions being contained in external audit reports, have a relationship with financial performance of the County Government of Nakuru. External Audit Outcomes was found to have a strong positive relationship with financial performance of County Government of Nakuru ($r=0.883$) and this relationship was found to be significant at 5% significance level ($p<0.05$).

VIII.RECOMMENDATIONS OF THE STUDY

The study recommends that the finance department of the County Government of Nakuru continually provides training to its officials to ensure that best practices in audit are embraced. The department should also encourage implementation of good financial management systems including internal control systems so that there are well maintained records and accounts which are readily available when information and explanations by external auditors are requested.

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