FINANCIAL MANAGEMENT PRACTICES AND FINANCIAL PERFORMANCE OF REGISTERED MICRO AND SMALL ENTERPRISES IN NAIROBI CITY COUNTY, KENYA

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ABSTRACT
Micro and Small Enterprises (MSEs) have a huge responsibility of promoting economic development of many nations in the world today. Studies from developed nations find financial management practices to contribute immensely to MSEs’ unfavourable business performance. The study investigated the relationship between financial management practices and financial performance of MSEs. Literature suggests that most research on the financial performance of MSEs is based on any one or a combination of the following key theories and frameworks: the Modern Portfolio Theory, the Signalling Model, and the Pecking Order Theory. A cross-sectional descriptive survey research study design was used. The target population of the study was 56,055 MSEs. The researcher used simple random sampling to arrive at a sample size of 384 licensed MSEs of the total population with at least one respondent in each. Multivariate regression model showed that firms’ overall financial performance was positively affected by the FMPs. The findings specifically showed that capital budgeting and capital structure management practices each had a significant positive effect on the company’s financial performance with Working Capital Management practices being the least contributor to the effect. The study found out that Working Capital Management is a leading financial management practice among MSEs has a significant negative influence on their financial performance. It is recommended that management of MSEs should put in place the most appropriate financial management practices to help them improve their return on assets.

Keywords: Micro and Small Enterprises, Financial Management, Financial Performance

INTRODUCTION
In Kenya, a micro-enterprise is considered to have from 1 to 10 employees, while a small enterprise is considered to have from 11 to 50 employees (Sikalieh, Linge & Asiimwe, 2016). According to Maina (2016), the potential of MSEs in both employment creation and generation
of incomes for many Kenyan families makes them a key element in the poverty reduction strategy. Compared to the manufacturing sector in Kenya, MSEs contribute over two times the GDP, and 75 percent of new jobs originate from the sector.

Moore and Reichert (1989) state that financial management practices refer to the budgeting practices carried out by managers of various departments including asset management, supply chain management etc. The most common financial management practices that have been widely used include Accounting Information Systems (AIS), Working Capital Management (WCM), Capital Budgeting, Capital Structure Management (CSM), Fixed Asset Management (FAM) and Financial Reporting and Analysis (FRA).

Capital Budgeting involves allocating or distributing financially-backed resources to be used for future investments. Since MSEs have minimal access to public funding, the small firms find capital budgeting a more important investment practice for them compared to large companies.

Capital Structure Management (CSM) according to (Romney, 2009) means overseeing the capital structure of an organization. The capital structure of a firm usually takes account of equity and equity. In both small and large businesses, debt includes long-term notes payable and bond issues, whereas equity takes account of retained earnings and common stock.

McMahon (1995) defines financial performance as the extent to which an enterprise is able to utilize its existing assets to make revenues. In an economic perspective, financial performance acts as a yardstick for measuring the financial wellbeing of a business’s over a specific period of time, which could be one month, three months, six months, annually etc.
Stock market values is one of the common ways for measuring financial performance of firms over time by finding the annual average change in the stock market. Furthermore, return on assets (ROA) and return on capital employed (ROCE) are the common accounting ratios that are used to measure profitability. ROA is an indicator of how profitable a company is relative to its total assets. ROCE measures the profitability and efficiency of a firm’s capital employed by dividing Earnings before Interest and Tax by Capital Employed.

Ochanda (2014) states that Kenya is one of the countries with high MSEs start-ups but non performing as well as closure of SMEs also high in numbers due to poor planning practices. A large number of distressed firms have been due to financial managers’ failure to control and plan the available resources being the business current assets and current liabilities of their respective firms. Pais & Gama (2015) goes ahead to emphasise that financial planning involves all departments of management as well as the financial effects of marketing, production, and investment decisions. However, these areas are currently not utilised by MSEs in Kenya and there is need to pay urgent attention to it.

The study sought to establish the effect of financial management practices on performance of MSEs in Nairobi County, Kenya. The specific objectives were; to examine the effects of capital budgeting on the financial performance of MSEs; to determine the effects of working capital management practices on the financial performance of MSEs; and to assess the effect of capital structure on the financial performance of MSEs’ all in Nairobi County, Kenya.

LITERATURE REVIEW

According to Amenc & Le Sourd (2003), the modern portfolio theory puts forward that investors can maximize their expected return by constructing a well-organized frontier portfolios. Garcia
et al (2017) states that investors can reduce their portfolio’s riskiness by placing their investments in more than one stock, as they also enjoy diversification. According to Spence, there are many instances of signalling, as individuals signal how they interact with others. Organizations signal as well in their advertisements, recruiting, and annual reports, just to name a few. Spence (1973) comprehensively delves into the hiring process of a company and associates it to investing in a Lottery game and states that an employer has to contribute to play. However, the employer would never know if he made a wise investment until the last number is picked. Signals are the unknowns that only observable personal attributes can describe; however, Spence (1973) denotes that signals are alterable, but indices are fixed. As stated by Khan & Yusop Adom (2015), firms usually aspire to keep asymmetric information exclusive because when they use internal funds, managers will not reveal their investment opportunities. According to Allini et al (2017), managers will usually protect their shareholders interest by working in favour of their firm, which is the second assumption. As such, the pecking order theory helps to give accurate details about the changes in the capital structure of a farm (Axelsson, Jakovicka & Kheddache, 2013).

As stated by Brigham (2012), compared to large business, capital budgeting is more important to small businesses since they cannot access funding from public markets. McMahon et al. (2008) reported that Soldofsky (1964) interviewed 126 owners of small manufacturing businesses in Iowa, reported the earliest study of capital budgeting of MSEs. Regarding capital project selection techniques, Soldofsky’s (1964) study results showed that only 4.1 percent employed accounting rate of return technique while 58% of respondents used payback period methods. Ratten’s (2014) conducted a study of 232 US-based small businesses, which pointed out that payback period method is the widely used method that small enterprises use for investment
selection (Meredith, 2013). Only a tenth of the firms confirmed that they use discount cash flow methods such as internal rate of return and net present value (D’Amboise & Gasse, 2006).

According to a survey conducted by Grtablowsky and Lowell (2008), SMEs have been inadequately utilising cash management practices. With a sample of 66 small businesses located in Norfolk, Virginia, the researchers concluded that a majority (67%) of respondents do not employ forecasting of their cash flows in any financial period within the year. Such results conclude that cash management practices have become a non-existent practice within many MSEs today even though most of them have started adopting the same. However, the study did not clearly handle other aspects of business efficiency such as financial planning. D’Amboise and Gasse (2006) conducted a survey of Canadian shoes and plastic firms to investigate the existing management techniques. According to the results, a majority (64% and 65.4% respectively) of the businesses incorporated formal systems for managing their inventory. On the other hand, Grtablowsky and Rowell (2008) carried out a similar study and found that most small businesses in Sydney, Australia invested a 30% surplus of working capital in inventory, a very poor management technique.

By bringing together hybrid securities, debt and equity, a firm uses capital structure to finance its assets (Holmes, 2003). As stated by Chechet & Olayiwola (2014), eighty percent of a company’s ratio of debt to total financing represents leverage. The management of MSEs calls for vital decisions centred on the firm’s optimal capital structure. Heikal, Khaddafi & Ummah (2014) defines capital structure as a combination of both debt and equity used to finance the operations of a firm. Explanations vary from the irrelevancy hypothesis to the optimal capital structure
where the cost of capital is minimized and the value of the firm maximized (Chechet & Olayiwola, 2014).

In a survey on the impact of corporate governance practices on performance of MSEs in Nigeria, Amoateng et al, (2017) utilised the annual reports of the MSEs from 2012 to 2016 financial years. Net Profit Margin (NPM) and Return on Assets (ROA) were used as proxies for performance and Ordinary Least Square (OLS) regression model was used to estimate the level of impact of corporate governance on the performance of MSEs in Ghana. The results showed that role difference for CEO and board chairman has a negative and positive impact on both ROA and ROE. Similarly, the results showed that board size (BS) has an insignificant negative impact on ROA. Generally, the evidence obtained show that corporate governance has positive but insignificant impact on performance of SMEs (Idawati & Wahyudi, 2015).

**Conceptual Framework**

**Independent Variables**

Financial Management Practices

- **Capital Budgeting**
  - Net Present Value
  - Internal Rate of Return

- **Working Capital Practices**
  - Cash Management
  - Inventory Management

- **Capital Structure**
  - Debt
  - Total Assets

**Dependent Variable**

Performance of MSEs

- Return on Assets (ROA)
  - Annual Earnings
  - Total Assets
METHODOLOGY

The study adopted a cross-sectional descriptive survey to collect, analyse and present data with the aim of condensing the research to become researchable. The study focuses on MSEs based in Embakasi which is the largest Sub-County of Nairobi County.

The study’s target population consist of MSEs owners, managers or accountants operating in Nairobi County, since they seem familiar with the use of budgets in their entities. The firms were categorised as micro (1 to 9 employees), and small-sized (10 to 49 employees) in the sub-county.

The target population was 56,055 registered MSEs in Embakasi Sub-County.

The researcher used a sample size of 384 respondents. The study used a multiple regression equation: 

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon \]

Where:

- \( Y \) = Firm performance as measured by Return on Assets (ROA)
- \( X_1 \) = Unit change in Return on Assets as a result of a unit increase in capital budgeting
- \( X_2 \) = Unit change in Return on Assets due to a unit increase in working capital management
- \( X_3 \) = Unit change in Return on Assets due to a unit increase in capital structure decisions.
- \( \varepsilon \) = Error term (The difference between the calculated DV value and the actual value).
- \( \beta_0 \) = Constant
- \( \beta_1, \beta_2 \) and \( \beta_3 \) are regression coefficients (indicates the rate of change of dependent variable as a function of changes in the independent variables).

FINDINGS
Table 1: Capital Budgeting

<table>
<thead>
<tr>
<th>Category</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determination of an investment budget</td>
<td>269</td>
<td>4.67</td>
<td>1.026</td>
</tr>
<tr>
<td>Search and identification of projects</td>
<td>269</td>
<td>4.78</td>
<td>9.69</td>
</tr>
<tr>
<td>Screening and definition of projects</td>
<td>269</td>
<td>4.63</td>
<td>1.171</td>
</tr>
<tr>
<td>Sector of business operation</td>
<td>269</td>
<td>4.36</td>
<td>1.193</td>
</tr>
<tr>
<td>Project appraisal and decision choice</td>
<td>269</td>
<td>4.25</td>
<td>1.201</td>
</tr>
<tr>
<td>Implementation</td>
<td>269</td>
<td>4.22</td>
<td>1.183</td>
</tr>
<tr>
<td>Control and post-audits</td>
<td>269</td>
<td>4.38</td>
<td>1.001</td>
</tr>
</tbody>
</table>

Researcher, 2018

Table 1 shows the respondents’ perception of on the importance of specific phases in the capital budgeting process. Analysis show that majority of the respondents (M = 4.78 and stdv = 0.969) indicated that the most important phase in the capital budgeting process was the search and identification of projects; project appraisal and decision choice; implementation; and control and post-audits (mean = 4.25, mean = 4.22 and mean = 4.38) had lower numbers of respondents. The results support Schall & Sundem (2013) who argued that decision-making is increasingly more complex today because of uncertainty and most capital projects assimilate several variables and possible outcomes.

Working Capital Management

The researcher also examined the indicators of working capital management to determine their effect on the performance of MSEs. Table 2 presents the working capital management summary of the research findings.

Table 2: Working Capital Management

<table>
<thead>
<tr>
<th>Category</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The company has a working capital management system</td>
<td>269</td>
<td>4.22</td>
<td>1.014</td>
</tr>
<tr>
<td>Maintains inventory records which are updated regularly</td>
<td>269</td>
<td>4.81</td>
<td>0.312</td>
</tr>
</tbody>
</table>
Table 2 shows the use of elements of WCM, with most respondents indicating that the firms maintain inventory records which are updated regularly (M = 4.81). Consequently, the respondents acknowledged the existence of WCM system in the firm (M = 4.22), and that they maintain proper records for all payables (M = 4.51). Lower numbers of responders indicated that the MSEs maintains optimal cash balances at all times (M = 4.29) and that receivables management system is fully automated (M = 4.16). Further, they indicated that their companies prepares cash flow forecasts to identify future surpluses and deficits (M = 4.45). The results support (Jameela, 2003) who recommended that MSE owners should put efforts to make sure that they improve the effectiveness of their WCM by using sophisticated methods.

**Capital Structure Management**

The study examined the manifestation of use of capital structure management to determine the extent to which it affects the performance of MSEs. Table 3 presents the capital structure management findings.

**Table 3: Capital Structure Management**

<table>
<thead>
<tr>
<th>Category</th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The capital structure of the company is appropriate</td>
<td>269</td>
<td>3.82</td>
<td>0.378</td>
</tr>
<tr>
<td>The company has fully utilized the debt facility</td>
<td>269</td>
<td>3.40</td>
<td>0.471</td>
</tr>
<tr>
<td>The company relies of debt only</td>
<td>269</td>
<td>3.52</td>
<td>0.509</td>
</tr>
<tr>
<td>The company relies on equity capital only</td>
<td>269</td>
<td>1.96</td>
<td>1.151</td>
</tr>
<tr>
<td>The company has foreign ownership</td>
<td>269</td>
<td>2.17</td>
<td>0.871</td>
</tr>
</tbody>
</table>
Table 3 shows the results on the capital structure management. The table indicates that most respondents ($M = 3.82$) with a $(stdv = 0.378)$ indicated that the capital structure of the company is appropriate. A high number of respondents ($M = 3.52$) also indicated that the company relies of debt only, which is a common phenomenon with MSEs under study. The least respondents $(Mean = 1.96)$ indicated that the company relies on equity capital only. The results reflect Mutanda (2014) conclusions that since MSEs have minimal access to public funding, they constantly borrow debts for financing.

**Research Questions Testing**

The previous section presented the descriptive statistics on financial management practices and performance of MSEs in Nairobi Kenya. However, in order to draw inferences about the population from the sample, the researcher applied the multivariate regression model to establish the relationship between the DV and IV. Table 4 presents the correlation between the observed and predicted values of the DV. It implies that its association of $0.913$ with financial management practices (Capital Budgeting, WCM, and CSM) and financial performance was very good.

**Table 4: Model Summary**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.913$^3$</td>
<td>.908</td>
<td>.895</td>
<td>.12761</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant) CBM, WCM, CSM

As shown in Table 4, R-Square measures the proportion of the variance in the DV as explained by variations in the IV. The implication is that there is $89.5\%$ of variance or correlation between DV and IVs, meaning financial management practices affect $89.5\%$ of variations leading to financial performance.
Table 5 represents the ANOVA statistics which was used to measure the significance of the regression model. The researcher applied an F-significance value of \( p = 0.000 \), meaning there is a 0.0% probability of getting erroneous information from the regression model.

**Table 5: ANOVA**

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>15.367</td>
<td>3</td>
<td>3.015</td>
<td>271.714</td>
<td>.000a</td>
</tr>
<tr>
<td>Residual</td>
<td>.633</td>
<td>12</td>
<td>.075</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>16.000</td>
<td>15</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant) CBM, WCM, CSM  
b. DV: ROA

Table 6 shows the regression coefficients which compares the level of independence to determine the variable that has greater effects on financial performance of MSEs.

**Table 6: Regression Coefficients**

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
</tr>
<tr>
<td>(Constant)</td>
<td>15.007</td>
<td>.499</td>
</tr>
<tr>
<td>CBM</td>
<td>.350</td>
<td>.049</td>
</tr>
<tr>
<td>WCM</td>
<td>-0.503</td>
<td>.049</td>
</tr>
<tr>
<td>CSM</td>
<td>.969</td>
<td>.027</td>
</tr>
</tbody>
</table>

a. DV: ROA

According to the table, the regression model established is as follows:

\[
\text{ROA} = 15.007 + 0.350X_1 - 0.503X_2 + 0.969X_3
\]

Where:

\( X_1 \) = Unit change in Return on Assets as a result of a unit increase in capital budgeting  
\( X_2 \) = Unit change in Return on Assets due to a unit increase in working capital management  
\( X_3 \) = Unit change in Return on Assets due to a unit increase in capital structure decisions.
The regression constant shows that when the IVs (Capital Budgeting, Working Capital Management and Capital Structure Management) are constant at zero, financial performance value would be 15.007. This indicates that the absence of the three FMPs would lead to dismal financial performance in MSEs.

The regression model also established that MSEs would improve their financial performance by 0.350 with a unit positive increase in capital budgeting if other factors remain constant. On the other hand, financial performance would decrease with a unit increase in WCM by a factor of 0.503 provided that other factors remain constant. Furthermore, with other factors constant, a unit increase in CSM would lead to a 0.969 increase in financial performance.

**DISCUSSION**

The analysis showed that a number of issues related to financial management practices affect the financial performance of the firms. To begin with, the study established that various financial management practices are commonly used by MSEs, and concurs with previous studies.

For instance, the researcher established that capital budgeting affects the performance of MSEs in concurrence with the findings of Schall & Sundem (2013) who argued that decision-making is increasingly more complex today because of uncertainty and most capital projects assimilate several variables and possible outcomes. Likewise, the use of WCM practice significantly influences the day-to-day operations of the firms, which eventually affects financial performance. These results concur with previous studies, as Ahmad, Rani and Kassim (2011) asserted that the importance of a good practice in WCM is stressed by the presence of an ideal level of its elements. As reflected in the results, Brigham (2012) advice that the management of
small firms should make timely decisions when acquiring capital equipment since it has the potential to improve the firm’s profits significantly. However, improper decisions may bring about dreadful consequences for the enterprise, since it would fail to sell capital equipment over the short term. From the research it can be concluded that capital budgeting, working capital management and capital structure management affect the financial performance of MSEs in Nairobi County Kenya.

CONCLUSIONS

The results of the study reveal that there is a positive relationship between financial performance success and the predictor variable capital budgeting. Therefore, this study concluded that MSEs have put in place robust capital budgeting practices for allocating or distributing financially-backed resources to be used for future investments.

The results of the study reveal that there is a negative relationship between financial performance success and the predictor variable WCM. This is because the businesses have failed to put up active cash management that reflect an inclination to invest surplus cash on a long-term basis.

Furthermore, the study found out that capital structure positively affects the financial performance of micro and small enterprises. Therefore, a firm’s capital structure stands out as one of the most important choices because from a technical perspective, it helps in balancing between equity and debt that a business uses to finance its assets, day-to-day operations, and future growth.
The findings specifically showed that capital budgeting and capital structure management practices each had a significant positive effect on the company’s financial performance with WCM practices being the least contributor to the effect. On the other hand, the study found out that working capital management has a significant negative influence on their financial performance. Therefore, it is important to acknowledge the positive effects because among the various FMPs, not all of them have the potential to improve the financial performance of all firms irrespective of the nature of their business activities.

**RECOMMENDATIONS**

It is therefore recommended that the management of MSEs should put in place the most appropriate financial management practices to help them improve their return on assets. As a case in point, they need to improve on the process of preparing and publishing the firms’ financial statements and capital structure as well as making sure that the management fully make use of debt facilities within their capabilities.

In addition, the researcher recommends that MSEs should begin encouraging each other to rely on and manage equity capital. The top management of the firms should also strive to make sure they are listed in the Nairobi Securities Exchange (NSE), which would definitely improve their capital base. Finally, this study recommends that MSEs should come up with the best strategies to minimize adverse effects on their financial performances.

**RECOMMENDATIONS FOR FURTHER STUDIES**

Since this research study limited its analysis with data collected from the sample population, future researchers should consider exploring larger samples because Kenya has registered MSEs
Effect of financial management practices on financial performance of registered micro and small enterprises in Nairobi City County, Kenya

sprinkled across the country. This will help in the accurate generalisation of results as well as taking into account the various environments in which they operate in order to compare other outcomes from similar studies.

The researcher experienced a number of limitations with the model used in this study: using ROA to represent financial performance. Future researchers should make use of other proxies to measure the effect of FMPs on the financial performance of MSEs. Furthermore, it is recommended that they should apply a different model to examine the relationship, which could solicit different results. Since this study restricted its scope to the MSEs sector in Nairobi, Kenya, further studies can focus on other sectors of the economy, which may exude diverse conclusions.

Furthermore, the researcher restricted the analysis of this study to the reluctant responses obtained from respondents using the questionnaire. As such, it is recommended that future studies should utilise other fit and reliable methods of collecting data including interviews, focus group discussions etc. to improve the response rate, which helps to streamline the findings.

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