THE EFFECTS OF FINANCIAL MANAGEMENT PRACTICES ON THE FINANCIAL PERFORMANCE OF THE TOP 100 SMALL AND MEDIUM ENTERPRISES IN KENYA

BY

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DECLARATION

This research project is my original work and has not been presented for examination in any other university.

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This research project has been submitted for examination with my approval as the University supervisor

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DEDICATION

This project is dedicated to my dear family for their encouragement and moral support through this research project, May the Almighty God bless you abundantly
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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>GoK</td>
<td>Government of Kenya</td>
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<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Statistics</td>
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<td>MPT</td>
<td>Modern Portfolio Theory</td>
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<td>OLS</td>
<td>Ordinary Least Squares</td>
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<td>SMEs</td>
<td>Small and Medium Enterprises</td>
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<td>WCM</td>
<td>Working Capital Management</td>
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ABSTRACT

This study sought to examine the effect of financial management practices on the financial performance of Small and Medium Enterprises in Kenya. The study focused on the Top 100 SMEs in Kenya as per the KPMG survey for the year 2017. Financial performance of SMEs was measured by SME’s Return on Asset for the year 2017. Within the study financial management was measured by working capital, dividend policy and capital budgeting decision.

Working capital was measured by the difference between current assets and current liabilities, dividend policy was measured by the dividend pay – out ratio, capital budgeting decisions was measured by a dummy variable of the adoption or failure of adoption of the capital budgeting techniques in investment valuation. On the moderating variable, total assets of the SME was used to measure the size of the business enterprise.

The core findings of the study were that in terms of the relationship among the variables, the Pearson correlation matrix results reveals that working capital has a positive relationship with the firm’s return on assets implying that they move in the same direction. Similarly, capital budgeting was found to have a positive relationship with the firm’s return on assets. The size of the firm was also found to be positively related to the return on asset for the SMEs.

However, dividend policy was found to be negatively related to SMEs’ return on assets implying that the two move in the opposite direction. With regard to empirical model analysis, results posit that that only the working capital and the capital budgeting decision are significant in informing the SMEs’ financial performance as measured by return on
assets. Dividend policy was found to have a negative but insignificant effect on SME financial performance.

Therefore, based on the study findings, the study recommends for the need for the SME to take in account policies that enhance effective working capital management to avoid short term illiquidity. Further, the study calls for the SMEs to consider adopting capital budgeting decisions in their investment evaluations and more so strive towards using a mix of techniques for an objective decision making on their capital investments.
CHAPTER ONE
INTRODUCTION

1.1 Background to the Study

From the financial literature and financial practice, it is evident that there exists no uniform definition of Small and Medium Enterprises. Therefore, the definition is dependent on the researcher’s point of interest. However, three broad definitions are mainly agreed upon based on entity’s total assets, total turnover and number of employees. For instance, the Sessional paper no. 2 defines a Small and Medium Enterprise as an enterprise running with 1-50 employees. On the other hand, the World Bank defines a Small and Medium Enterprise as a formerly registered business entity with an annual turnover of Ksh 1-100 million and with an asset base of at least Ksh 4 Million and with 5-150 employees.

In the Kenya context, Small and Medium Enterprises have over the years been recognized for their critical role in provision of goods and services, enhancement of competition, generating employment and in effect alleviation of poverty. The crucial role of SMEs is underscored in Kenya’s development blueprint as stipulated in Kenya’s Vision 2030, which seeks to transform Kenya into an industrialized middle income country, providing high quality of life to its citizens by the year 2030 (KNBS, 2016).

Financial Management determines the organizational decisions that institutions make which are tools used to analyse and make the decisions. According to Pandey (2010), the lasting and temporary resolutions models share similar objective of improving worth of company by making sure that gains from capital is higher than the cost of capital, while not taking much economic risks. Further, Gitman (2011) asserts that financial management
practices applied the models of money, time and risk and the way they relate to each other. As such, financial management can be deduced as the act of ensuring that financial resources together with dealing decisions in regard to accounting, financial reporting and budgeting, capital budgeting decisions are also dealt with. The concerns that are dealt with are like lease or buy property, and whether to use debt financing method or equity technique. This is a function in the organization that has a grant determinant of success in small and medium enterprises.

According to Schnittgrund and Baker (1983) financial management combines financial management practices and outcome results like frequency of saving and type of budget used. Research has shown that businesses believe that financial management practices like budgeting and saving are valuable. World Bank (2015) posit that formal SMEs contribute about 45% to total employment and 33 percent to GDP in emerging economies. However, the report is also cognizant of the various challenges facing these enterprises from limited access to financing, poor record keeping, inadequate technical skills, cheap imports, stiff competition, low levels of education, poor market information, inhibitive regulatory requirements, insecurity and debt collection.

Ryan et. al (2014) observed limited access to external financing by SMEs with most banks limiting funding to small enterprises compared to large enterprises. Unfavorable government policies impact negatively on the performance of SMEs with notable decrease in issuance of total credit by commercial banks (Eniola and Entebang 2015). Weak institutions and limited access to credit contribute immensely in hindering growth of SMEs considering legal systems and flow of information (Beck & Demirguc – Kunt 2006). Ngui
(2014) observed a stagnant rate of formation of new firms and collapse of established SMEs within 5 years of starting operation.

A World Bank Report identified low intellectual capital utilization by owners of SMEs as a key concern that impacts negatively on the gross domestic product (World Bank, 2010). Whereas relatively large organizations have clearly defined financial structures and well executed financial management practices, SMEs more often than not tend to have underdeveloped financial management practices as they try to manage their expenditures and maximize profits (Bancel & Mittoo, 2004).

This study will be based on the contingency theory and pecking order theory. First, the contingency theory focuses on financial management practices that seek to ensure optimal resource allocation in an organization to enhance financial performance. The theory is applicable in this study in the sense that just as the theory proposes, there are certain financial management practices that may work well with certain corporates and not with others. This is supported by the difference in the organizational settings and the external factors that affect organization operations. This is the salient feature of the SMEs that are very dynamic in their settings as well as their way of operating. Therefore, given the dynamism of the SMEs, there are no standard financial management practices that are applicable to all SMEs at a go. The implication here is that the appropriate financial management practices should be chosen upon the evaluation of the SMEs setting and the environment within which it operates (Myers and Majluf, 1984).

Secondly on the pecking order theory, the theory is majorly concerned with the firm’s capital structure which states that firms have a preferred hierarchy for financing decisions
in their attempts to prudently manage their financial resources. The application of this theory in this study is based on the understanding that pecking order theory help management in ranking the possible sources of finances that is whether to finance operations using internal or external funds. Therefore, if an SME wants to make investments decisions such as business expansion, the ordering of the sources of funds for expansion would be crucial to ensure that it does not suffer from working capital challenges. In this case, the firm may opt to take a debt to finance expansion rather that use internal funds such as retained earnings (Pike, 1986).

1.1.1 Financial Management Practices

Financial management practices are those techniques executed by accountants and other specialists in the department of budgeting and related departments (Moore and Reichert, 1989). Financial management practices include management of working capital which is a strategy focused at ensuring efficient financial resource allocation. In addition, the working capital is an asset that a firm convert into cash in a short period of time. Further, balancing the right mix between equity and debt is also a core financial management practice in finance.

According to Boateng, (2004) capital structure is a subset of financial structure and these are originators of enterprise financing which are permanent. It has a great impact on a given economic system and it is prudent for a company’s management to identify the most ideal capital structure. Other financial management practices include capital investments decisions which deals with evaluation of investment choices for the firm. The constraints and objectives affecting project selection are highly important. Within the investments and financing strategies projects decisions ought to be objectively guided by their respective
Internal Rate of Return, Net Present Value, Accounting Rate of Return and Payback Period. These will in overall inform the Return on Equity and Return on Assets which are financial performance ratios of evaluating financial performance of an entity. It is therefore evident that the financial management practices are crucial in informing the business financial performance (Schnittgrund and Baker, 1983).

1.1.2 Financial Performance

Financial performance is a general measure of how well a business generates revenues from its capital. It outlines the degree to which financial objectives have been achieved. It also indicates overall financial health of a business over a period of time. According to McMahon, (1995) financial performance is an independent determination of how well a business uses its assets to create and increase income. Within the financial literature, the financial performance of the business can be assessed by a number of indicators. Most of these indicators are mainly the financial ratios. The mostly used ratios to measure the financial performance are the Return on Asset and Return on equity. The two ratios capture the financial profitability of the business.

According to Hansen and Mowen (2005), operating and net income can also be used to measure the financial performance of the business. The Return on Asset basically measures how the business is making profit by utilizing its assets. It therefore gives an impression as to how well the business of managing its assets to generate income. On the other hand, the Return on Equity measures how the business is making profit by utilizing the shareholders’ funds. It therefore gives an impression as to how well the business of managing its shareholders’ equity to generate income. These ratios are also significantly related to the financial performance of the business.
1.1.3 Financial Management Practices and SMEs Financial Performance

Financial management practices are important to small and medium enterprises since they can help the business to overcome various challenges they face (Uluyol, 2013). The ultimate aim of financial management practices is to help business increase their wealth. Financial management methods are imperative to accomplishments of a business for financial planning, capital budgeting, management accounting and controlling of working capital. Working capital is critical as it helps a business to meet its daily financial obligations. Accounting and budgeting helps a business to attain transparency and accountability in its operations. Proper management of capital structure helps achieve proper coordination of all financial practices in the business. Risk management helps a business to prepare and institute mechanisms in the event of an unfavorable occurrence.

These financial management practices when integrated in the operations of a small and medium business help to improve their financial performance and therefore enable them to be conducted in an effective and efficient way using appropriate financial decisions to maximize the company’s resources (McMahon, 1995). Extra expenses are however expected to be incurred when these financial management practices are adopted leading to a burden to the business which could translate to diminished returns (Abanis et al, 2013). These could cause some small business owners shun away from implementing financial management practices. Other factors exert a leveling effect in the manner the financial management practices impact on organizations e.g. the size of a firm, the degree of risk, capital intensity and leverage. These factors must therefore be considered when formulating an organization’s financial management practices (Moore and Reichart, 1989).
1.1.4 Small and Medium Enterprises in Kenya

According to National MSME Survey report (KNBS, 2016) the role of SMEs in promoting economic growth and development cannot be overemphasized given their economic wide spillover effects. Further, this is supported by the findings of the Economic Survey, the sector continues to support economic growth and development by continued adoption of various financial management practices thus contributing to their enhanced financial performance. The survey furthers asserts that SMEs in Kenya operate across all the sectors of the economy and have adopted different financial management impacting their financial performance differently. However, they tend to be more active in some key sectors such as trade, manufacturing and service sector and SMEs in these sectors have witnessed higher adoption of financial management practices compared to other sectors and comparatively impressive financial performance.

Bare (2016) undertook a study on the effects of financial accounting standards on the financial performance of SMEs in Kenya. The study found out that adoption of financial accounting standards impacted positively on the performance of SMEs in Kenya. Ouma and Kilonzo (2015) tried to establish adoption of financial management practices by SMEs in Kenya. Out of a sample of 41 firms in Kenya they established that 35% invested in long term assets, 75% of SMEs sold their products on a cash basis, 92% maintain a manual inventory register, 74% prepared financial statements using an unqualified accountant, 55% do not use a formal accounting system and 45% used funds generated internally.

Given these challenges and based on the realization of the crucial role of SMEs in the Kenya economy, it’s notable that the government has of late embarked on efforts toward formalization of the sector in order to tap on the full potential of the sector. This has seen
the creation of Micro and Small Enterprises Authority (MSEA); a comprehensive body governing SME matters. The Authority has embarked on increasing intellectual capital utilization by owners of SMEs as a key concern that informs adoption and integration of financial management practices in the day to day running of SMEs businesses in Kenya (KNBS, 2016).

1.2 Research Problem

Small and Medium Enterprises play a fundamental role in the economy through improving economic growth as well as reducing wealth inequalities in communities. This argument is in tandem with Hallberg (2000) who posit that SMEs significantly contribute towards economic growth and development through reduction in poverty levels and job creation. Moreover, the government of Kenya has identified these entities as potential pillars towards job creation especially among the youth given the high rate of unemployment that is estimated at approximately 34 percent as at the year 2014 (Kenya National Bureau of Statistics, 2014).

However, despite the realization on the crucial role that Small and Medium Enterprises play in an economy, these entities in Kenya still face many challenges. Majority of them tend to have a short lifespan, inadequate access to financial services among others. From the research point with regard to financial management practices and financial performance nexus among the SME it is clear that most of studies have associated financial performance to other factors. A number of international studies have reviewed the effect financial management practices on corporate performance. Hunjra et al (2016) reports a positive effect of liquidity management on the financial performance of listed companies on the Karachi stock Exchange. On the contrary, Jain (2010) report negative significant
relationship between cash conversion cycle and firm profitability and positive relationship between current ratio and profitability of firms.

Further, Zariyawati, Annuar, Hassan and Abdulrahem (2014) evidence negative significant relationship between cash conversion of cash cycle and firm profitability. Saah (2015) found that financial management practices mainly accounting information systems, investing activities, and financing and working capital management have positive impact corporate returns. However, the studies are unclear on whether the corporates cover in their analysis are SMEs with some being evident that they cover large corporates.


It is therefore clear that financial management practices influence on performance of SMEs has been scantily established with precision. More specifically, financial management practices on matters such as working capital management, keeping proper financial records, keeping audited records, supplier vetting, putting in place necessary financial controls to monitor expenditure such as ensuring expenditure originator is different from expenditure approver among others have not been critically focused on in the existing local studies. This presents the study gap that this study seeks to fill in by focusing on these
specific financial management practices and their effects of SMEs’ financial performance in Kenya.

1.3 Objective of the Study

This study is aimed at examining the effects of financial management practices on the financial performance of The Top 100 Small and Medium Enterprises in Nairobi County.

1.4 Value of the Study

The value of this study will be three – fold. First, is the value to the potential financiers or financial lenders to the Small and Medium Enterprises. These will range from commercial banks, microfinance institutions, non – bank financial institutions among other potential lenders to SMEs. The findings of the study would be of help to such lenders in helping them to objectively evaluate the financial soundness of the SMEs at hand. This would further enable them to perform an objective risk pricing of such SMEs prior to advancing credit facilities to them. In the long run, this would aid the lenders avert the potential risk of non – performing loans that adversely affect their asset quality. In addition, the findings would also be of help in scenarios whereby the lenders want to provide capacity building services among the SMEs.

Secondly would be the significance to the management of the SMEs. The findings of the study would be of help in enabling the management to match their financial management practices to performance. This would therefore aid in development and adherence to best practices in financial management within their institutions. This would in turn help them manage any financial risks that are likely to financial management malpractices. In addition, such information on the relationship between financial management practices and
financial performance would aid the management to adhere to the best management practices which would in the long run enable the firm to access financial services.

Thirdly is the contribution to literature. The study will also add to the existing body of knowledge and stimulate further research on different aspects of financial management practices that have been adopted by SMEs in Kenya given that these SMEs operate in a very dynamic business environment.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This section reviews literature pertaining financial management practices and financial performance. Specifically, the chapter reviews the theoretical literature on the financial management practices and financial performance of the organization. In addition, it covers the empirical studies on the effect of financial management practices on financial performance of an organization. The chapter finalizes with a summary of the reviewed literature and research gap that the study seeks to fill in.

2.2 Theoretical Review
The study will be underpinned on theories that support the concept of financial management practices on the organization. Therefore, this study will be anchored on three main theories namely: Contingency Theory, Pecking Order Theory and Modern Portfolio Theory. These theories and their relevance in this study are discussed below:

2.2.1 Contingency Theory
Contingency theory was advanced by Pike (1986). It focused on financial management practices that seek to ensure optimal resource allocation in an organization. The theory focuses on three aspects of the corporate context which are assumed to be associated with the design and operation of a firm’s capital budgeting system. These include: the organizational characteristics, environmental uncertainty and behavior characteristics.

Under the organizational characteristics, the theory asserts that smaller, less complex organizations tend to adopt interpersonal, less sophisticated control systems. However, its
notable that Haka, Gordon & Pinches (1985) are of a contrary opinion. They postulate that firms will experience more benefits from using sophisticated capital budgeting techniques. According to them, implementation of sophisticated capital budgeting procedures is one of many means of coping with acute resource scarcity in an organization. Their argument is anchored on Schall & Sundem (1980) who had earlier on theorized that use of sophisticated capital budgeting techniques declines as environmental uncertainty increases.

Turning to the environmental uncertainty, contingency theory is cognizant of the fact that the more variable and unpredictable the context of operation is, the less appropriate will be the highly bureaucratic, mechanistic capital budgeting structures. It suggests that corporates that operate in highly uncertain environments are assumed to benefit from sophisticated investment methods, particularly in appraising risk. This therefore informs the financial management practices that such firms would adopt in align with their working environment (Haka, Gordon & Pinches, 1985).

Regarding the behavior characteristics, contingency theory identifies three characteristics, namely: the management style, degree of professionalism and the history of the organization. Therefore, an administratively-oriented capital budgeting control strategy is assumed to be consistent with analytical style of management, a high degree of professionalism and organizational history (Haka, Gordon & Pinches, 1985).

Contingency theory will be applicable in this study in the sense that just as the theory proposes, there are certain financial management practices that may work well with certain corporates and not with others. This is supported by the difference in the organizational
settings and the external factors that affect organization operations. This is the salient feature of the SMEs that are very dynamic in their settings as well as their way of operating. Therefore, given the dynamism of the SMEs, there are no standard financial management practices that are applicable to all SMEs at a go. The implication here is that the appropriate financial management practices should be chosen upon the evaluation of the SMEs setting and the environment within which is operates.

2.2.2 Pecking Order Theory

Pecking order theory was advanced by Myers and Majluf (1984). The theory is majorly concerned with the firm’s capital structure. The firm will therefore rank the possible sources of finances based on the perceived cost of raising them. Going by the argument of the theory, the firm will therefore have preference in using internal financing such as retained earning given their low cost of raising them. As such the external fund follows with the equity being the last resort given the high cost associated with the raising the equity.

The application of this theory in this study is based on the understanding that pecking order theory helps management in ranking the possible sources of finances that is whether to finance operations using internal or external funds. Therefore, if the SME wants to make investments decisions such as business expansion, the ordering of the sources of funds for expansion would be crucial to ensure that it does not suffer from working capital challenges. In this case, the firm may opt to take a debt to finance expansion rather that use internal funds such as retained earnings. In ranking the firm’s sources of finances in line with the financial situation the firm faces, this brings the idea of financial management
practices which this study deals with. Similar thought process can be alluded for SMEs whereby for proper financial management, they ought to rank the possible sources of finances at their disposal based on their financial circumstances hence the application of pecking order theory thus avoiding financial challenges in future.

2.2.3 Modern Portfolio Theory

Modern portfolio theory was advanced by Markowitz (1952). The model seeks to find most efficient financial portfolio that maximum expected returns at the lowest cost possible. The idea of the theory is to maximize the expected return based given the market risk at hand. As such the choice of the portfolio by the investor is dependent on the market risk associated with the portfolio. The investor will choose the portfolio that has the least market risk compared to others.

In the case for SMEs, this theory is crucial with regard to financial management practices touching on the firm’s investments practices. Therefore, in making investment decisions, SMEs will choose an investment portfolio considered efficient if it gives the investor a higher expected return with the same or lower level of risk as compared to another investment. Therefore this theory promotes the firm to undertake investment decisions and related activities with lot of seriousness. By so doing the theory tries to encourage firms to embed prudent financial management practices regarding to investment hence its importance in this study.
2.3 Determinants of Financial Performance of SMEs

From the theoretical as well as the empirical literature, there are a wide range of the factors that determine the financial performance of an enterprise SMEs not being an exception. Among the major factors influencing the SMEs’ performance are discussed in this section.

2.3.1 Access to Finance

Universally, the limited access to credit finance has been indicated as a key problem for SMEs. This is basically characterized by the high cost of credit, high bank charges and fees, lack of collateral and failure to meet banks vetting procedures that constraint the SMEs from accessing financial resources hence having a negative effect on their performance. The SMEs therefore tend to rely on borrowings from friends and family as well as own savings which are inadequate in meeting all their financial needs (Macharia 2012). The limited access to finances negatively impacts on the financial performance of the bank by limiting their technology choice.

Limited access to finances hinder SMEs from acquiring advanced technology that is capable of enhancing efficiency in their operations. They therefore tend to continue operating in the old technology. According to Nyambura (2010) small enterprises cannot afford to use modern Information Communication Technology to automate their operations hence resulting to high operation cost and inefficiency that comes with the reliance of manual ways of doing things.

In addition, the limited access to finances by the SMEs imply that they have limited alternative sources of finances. This means that they are left to rely on informal sources of finances that are costly compared to formal sources of finances. The high cost of the
informal financial sources that SMEs rely on negatively affects their financial profitability hence adversely affecting their financial performance (Kinyanjui, 2006).

2.3.2 Human Resource Capability

Skilled human resource in a business entity is an asset that is core in creating competitive advantage with the business. This is the argument of Resource Based Theory. Human capacity has emerged as a crucial measure of business competition. (Tim & Brinkerhoff, 2008). It creates competitive advantage of the firm compared to others (Evans et al., 2002). Further, adoption of human resource development will lead to competitive advantages for the SME’s hence enhancing the firm’s survival (Evans et al., 2002). Lack of professionalism has negatively impacted SMEs’ performance. According to Cant and Lightelm (2003) limited skilled human resource arising from the inadequate financing needed to procure such labor force, has led SMEs to be left to rely on cheap labor most of which is drawn from the family which is majorly unskilled. This results to inefficiency in operation thus impacting on the financial performance negatively (Oladipupo & Abdulkhadir, 2010).

2.3.3 Corporate Governance

Corporate governance is the systems and processes of managing company’s affairs (Jensen, 2007). SMEs that have incorporated corporate governance in their operations are more likely to have better financial performance compared to those that do not (Claessens et al., 2002). Incorporation of corporate governance in SMEs is likely to attract foreign investors thus unlocking the problem of limited access to financial resources hence improved financial performance in the long run hence positive effect of SMEs performance (Gemmill
and Thomas, 2004; Williams (2000) and Drobetz et al., 2005. Adoption of corporate governance comes with rise in corporate profitability that arises from increased efficiency in operations. The end result is increased shareholders’ wealth (Petra, 2005). With good corporate governance system in an organization, potential risks are mitigated hence increased return on investments.

2.3.4 Macroeconomic Environment

The economic environment within which the SMEs operate is a major determinant on their financial performance. SMEs will tend to perform well if the macroeconomic environment within which they operate is supporting to anchor growth. A good and favorable economic environment ensures that there is ready market for SMEs products and services through increased demand (Ngui, 2014). A turbulent favorable economic environment on the other hand characterized by high inflation rate, slow economic growth, high interest rates, high taxation rates among others hinder the growth of SMEs hence leading to poor financial performance. This is underpinned on the fact that unfavorable economic environment characterized by high inflation rate, slow economic growth, high interest rates, high taxation rates comes with increment in cost of doing business via high cost of production hence having a negative effect on financial performance.

The study will be conceptualized that the SMEs financial performance depends on the effectiveness and efficiency in managing the business while focusing on the good financial management practices. According to the conceptual framework, the core financial management practices to be focused in this study will include: working capital management practices, capital budgeting and financial reporting and analysis.
2.4 Empirical Studies

There exists a vast body of empirical studies with regard to effect of financial management practices on the financial performance of corporates. Some of the studies relevant to this study are discussed in this section.

Jama, Samantar and Muturi (2017) examined the effect of liquidity management practices on the profitability of 46 bottled purified companies in Garowe and Bosaso towns of Puntland in Somalia. Using primary qualitative data collected via interviews, the study concluded that liquidity management is a key management tool seeks to establish the financial position of an organization. Using multiple regression analysis, the study finds that cash flow management has a positive effect on profitability of bottled purified water companies. Whereas the study provides useful insights into the role of working capital management on profitability, it ignores other aspects of financial management practices, especially investing and financing practices. In addition, it focuses only on water companies and therefore fails to capture the effect of liquidity management on other types of companies.

Hunjra et al (2016) analyzed how liquidity management on the financial performance of listed companies on the Karachi stock Exchange. The study found that liquidity management has a positively influences financial performance of listed companies. However, on contrary Afza and Nazir (2008) conclude a negative effect of working capital management on firm profitability in Pakistan. Jain (2010) in studying the effect of working capital management on profitability of 4 oil drilling firms in India for 2005 to 2009 period
reports that cycles of cash conversion negatively impacts on and firm profitability. However, the current ratio was reported to positively influence profitability.

Similarly, Zariyawati, Annuar, Hassan and Abdulrahem (2014) analyzed how the working capital management on corporate firm profitability for 1628 firms in Malaysia for 1996 - 2006 period. The study used cash conversion cycle as a metric of liquidity management. The Pooled Ordinary Least Squares (OLS) results support evidence of a strong and significant negative effect of cycles of cash conversion and the profitability of the firm. This calls on the need for the firm to lower its cash conversion periods.

Further, Mohamed and Omar (2016) carried out a study on the effects of cash management on profitability of private schools in Mogadishu, Somalia. The study found out that the Private schools cash collection positively affects the financial performance of Private Schools. The findings indicated that cash management has high effect on financial performance of private secondary schools in Mogadishu, Somalia.

Kilonzo and Ouma (2016) studied the effects of financial management practices on growth of small and medium enterprises. The study focused on manufacturing enterprises in Nairobi County. Using data from 41 firms sampled from Kenya Association of Manufacturers database, the study established that three – quarters of the SMEs make cash sales. Limits on cash is observed by 82% of the sampled firms. 55% were found to lack a formal accounting system and 74% having unqualified accountant preparing financial statements.
Vohra and Dhillon (2014) investigated the effects of financial management practices on financial performance of 103 small firms in India. The study reports a positive effect of working capital management, effective financial reporting, proper inventory management, and adoption of capital budgeting activities on firm’s profitability. Saah (2015) conducted a study on the effect of financial management practices on the profitability of SMEs in the Tamale Metropolitan area of Ghana. The study was conducted through cross sectional design and used mainly primary data. Using the Pearson’s correlation co-efficient and multiplicative linear regressions the study found that financial management practices mainly accounting information systems, investing activities, and financing and working capital management have positive impact on SMEs’ returns.

Rathnasiri (2015) analyzed the influence of financial management practices on Sri Lanka SMEs’ financial performance. The study report that financial management practices employed with respect to different areas of businesses vary with the level of education of the owner/manager, size, legal form, leverage and location. Using non-parametric tests, the study concluded that the number of operative years under existing management as well as the location of the business did not determine major differences in adopting financial management tools and techniques. The study implies that the financial practices to be employed varied based on the SMEs but the relationship that existed was not well established.

In the Kenyan context, a number of studies have been conducted with regard to financial performance and financial management practices. Bare, (2016) conducted a study on the extent of adoption of financial accounting standards and its effect on SMEs’ financial performance in Kenya. The study only focused on adoption of financial accounting
standards. Using a sample size of 86 SMEs, which were sampled using stratified and simple random sampling. The study found out that adoption of financial accounting standards had a positive effect of financial performance of SMEs. However, the effect was found to be insignificant. However, this study failed to establish the existence of other financial management practices in the SMEs but only focused on financial accounting standards.

Kilonzo and Ouma, (2015) examined how SMEs in Kenya have adopted financial management practices. The study was based on 41 firms from Kenya. They found that 45% used funds generated internally for business financing, 35% have invested in long term assets, 82% maintained a cash limit, 75% of the SMEs sold their products cash, 92% have a manual inventory register, 74% prepared financial statements without a qualified accountant while 55% do not employ the use of a formal accounting system. However, the study failed to link the specific financial management practice to firm performance but rather summarized the financial management practice used by the SMEs. Bowen, Morara and Mureithi (2009) investigated the challenges facing SMEs in Nairobi among 198 sampled SMEs registered in Nairobi. The study found that SMEs have constrained access to credit, security, debt collection, inability to manage financial systems, competition among themselves and from large firms and cheap imports. They concluded that adherence to financial management practices among SMEs is very low.

Farhatali, (2017) examined the influence of strategic financial management on small and medium enterprises’ performance in Nairobi Central Business District. Using a descriptive research design approach for the sampled entities, the study showed that SMEs managers
believed that inventory and cash management influenced their business’ profitability and risk. Further, SMEs were found to use informed intuition in assessing the practicality of potential investment opportunities. However, the study failed to look at other financial management practices such as financial reporting and accounting systems. In addition, the study failed to quantify the effect of the concerned practices on SMEs performance.

2.5 Conceptual Framework

Based on the theoretical and empirical literature, the conceptual framework on the study is outlined in figure 1 below.

**Figure 1: Conceptual Framework**

From the conceptual model, the study conceptualizes the financial management to be captured by working capital managements, financial reporting and analysis and capital budgeting activities. The working capital management will be measured by the entreprise
having short term deposits, enterprise cash requirements, and the cash receivable cycles. Further, dividend policy will be measured by the dividend payout ratio of the SME. Lastly, is the enterprise incorporation of capital budgeting activities in its operations which will be measured by investments analysis, investing in the income generating activities and taking into account inflation aspects in the budgeting process. This study is also cognisant of the fact that an enterprise does not operate in isolation of the moderating environment. As such the study incorporates the size of the enterprise as a moderating variable in the study. Which will be captured by the total assets or the net sales of the enterprise. With regard to the financial performance of the enterprise, return on assets, return on equity and net profitability will be used to measure the performance of the enterprise.

### 2.6 Summary of Literature Review and Research Gap

From the revised literature, it is evident the role of SMEs in any economy cannot be overemphasized. From the theoretical point of view SMEs in the exercise of financial management practices, of the core practices are liquidity management practices, financial reporting, and investment practices and accounts information systems. The empirical literature evidence that financial management practices have a positive effect on firm’s financial performance.

From the reviewed empirical works a number of research gaps can be elicited. First, majority of the international studies seems to mainly focus on liquidity / working capital management (Hunjra, 2016; Jama, Samantar and Muturi, 2017; Jain, 2010; Zariyawati, Annuar, Hassan and Abdulrahem, 2014 and Mohamed and Omar, 2016). These studies are therefore mute on the effect of other financial management practices apart from working capital management. At the local levels, the studies have also focused on some financial
management practices but left others. Further the findings of these studies are inconclusive in their findings with some of them being unable to conclude the link between financial management practices and firm performance (Farhatali, 2017; Bowen, Morara and Mureithi, 2009; and Kilonzo and Ouma, 2015).

This study seeks to fill in the gaps elicited in the reviewed studies as follows: First, the study will focus on all the four core financial management practices namely: liquidity management, investment activities, financial reporting and accounting information systems in its analysis. Secondly to link the practices with financial performance, the study will employ multivariate regression model. Thirdly, the study will employ inferential statistics analysis to analyze the link between financial management practices with financial performance.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter covers the research methodology that will be employed in carrying out the study. More specifically, the chapter covers the research design of the study, the target population, sampling techniques and sample size, data collection methods, measurement of variables and data analysis techniques.

3.2 Research Design
This study will adopt a descriptive research design. Specifically, the study will adopt a survey research design. A survey of all the SMEs in Kenya will be undertaken. Descriptive research design involved primary data collection Glass & Hopkins (1984). The design involves collecting data either via questionnaires, observation among other methods of collecting primary data. The study seeks to establish the relationship between financial management practices and performance of The Top 100 SMEs in Kenya and therefore descriptive research design would be ideal.

3.3 Target Population and Sampling Technique
The target population of the study will be the Top 100 mid-sized companies. This is guided by the KPMG database for year 2017. According to the database, the top 100 SMEs are drawn from various sectors of the economy namely: manufacturing, transport, service, real estate, health, information and communication technology, tourism and hospitality, trade and agriculture sector. In total the target population for the study will be 100 entities. From the target population, the sampling frame is defined as follows in table 1.1: The study will
employ the census for data collection. Therefore, the study will cover all the 100 companies covered by KPMG in their survey. As such there will be no need for sampling but rather a census of all the 100 companies will be conducted. Therefore, the sample size will also be the sampling frame.

Table 1.1: Sampling Frame

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>13</td>
</tr>
<tr>
<td>Transport</td>
<td>4</td>
</tr>
<tr>
<td>Service</td>
<td>43</td>
</tr>
<tr>
<td>Real estate</td>
<td>1</td>
</tr>
<tr>
<td>Health</td>
<td>6</td>
</tr>
<tr>
<td>Information communication technology</td>
<td>10</td>
</tr>
<tr>
<td>Tourism &amp; Hospitality</td>
<td>4</td>
</tr>
<tr>
<td>Building &amp; Construction</td>
<td>7</td>
</tr>
<tr>
<td>Trade</td>
<td>11</td>
</tr>
<tr>
<td>Agriculture</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

*Source; KPMG, (2017)*

3.4 Data and Data Collection Tool

The study will utilize secondary data. The data will be obtained from KPMG regarding the adoption of financial management practices by KPMG which was collected using questionnaires. However, with regard to SMEs financial performance, the data on their financial performance (return on asset) for year 2017 will be obtained from the financial reports of the SMEs at hand. This will aid in analyzing the trends in financial performance of the concerned firms.
3.5 Data Analysis

Upon data collection, the data will be cleaned up to ensure no inconsistent responses for the sampled firms. The data will then be entered in computer using the SPSS version 20. Upon data entry, the relevant data coding will be done to convert the qualitative data into quantitative data for analysis work. The data will be tabulated, classified and summarized by descriptive measures such as frequency distribution, percentages, inferential statistics mean and standard deviations. In addition, a multiple regression model will be estimated using Ordinary Least Squares Method will be estimated to quantify the effect of financial management practices on financial performance.

3.5.1 Analytical Model

In order to determine the effect of financial management practices on financial performance, a multiple regression model will be applied. Ordinary Least Squares Method will be used to obtain the coefficients, standard errors and the respective p-values of the independent variables. These will then form the basis for hypothesis testing. The study will assume a linear relationship among the model variables. The following multiple regression model will be applied.

\[ Y = \alpha_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon \]

Where:

\( Y \) is the Profitability of SMEs

\( X_1 \) is the Working Capital Management

\( X_2 \) is the Dividend Policy
X_3 \text{ is the Capital Budgeting}

X_4 \text{ is the Firm Size}

\alpha \text{ is the constant term for the model}

\varepsilon \text{ is the error term of the model}

3.5.2 Measurement of the Model Variables

The variables to the model will be measured as defined in table 3.1 below:

<table>
<thead>
<tr>
<th>Variables</th>
<th>Definition</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability</td>
<td>Refers to the income in excess of operating expenses</td>
<td>Returns on Assets of the SME for year 2017</td>
</tr>
<tr>
<td>Working capital management</td>
<td>Refers to the management of the relationship between a firm's short-term assets and its short-term liabilities.</td>
<td>The difference between current assets and current liabilities of the SMEs in year 2017</td>
</tr>
<tr>
<td>Variables</td>
<td>Definition</td>
<td>Measurement</td>
</tr>
<tr>
<td>------------------------</td>
<td>----------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Dividend policy</td>
<td>Refers to the company's approach to distributing profits back to its owners or stockholders.</td>
<td>Measured by dividend Payout ratio (DPR) for SME in year 2017; ( DPR = \frac{\text{Dividends}}{\text{Net Income}} )</td>
</tr>
<tr>
<td>Capital budgeting</td>
<td>Refers to the process by which a company determines whether a project is worth pursuing.</td>
<td>Measured by whether the SMEs undertakes investment appraisal prior to investing by using various techniques such as computing payback period, Internal rate of return and Net present value</td>
</tr>
<tr>
<td>Firm size</td>
<td>Refers to the amount of capital invested in the SME</td>
<td>Measured by the total assets of the SME for year 2017</td>
</tr>
</tbody>
</table>

3.5.3 Diagnostic Test

(i) Correlation Analysis

Correlation analysis establishes the strength of association between variables and hence indicates the nature of relationship between the variables (Kothari & Garg, 2014). In order for such an analysis to be done, the following need to hold: linear relationship, no significant outlier to introduce distortion of results, and absence in the data of strong non-
normality. In this study, the technique Pearson’s correlation analysis will be applied to test for the association levels among the independent variable and the dependent variable.

(ii) Normality Test
It is always assumed in inferential statistical procedures such as Analysis of Variance and the simple regression analysis that the sample is derived from a normally distributed population. According to Saunders et al (2014), normality test compares the scores in the sample to a scores that are normally distributed bearing similar mean and standard deviation with the null hypothesis assuming a case of normal distribution of the sample. In this study, Shapiro-Wilk test will be applied to test for normality within the regression model.

(iii) Heteroscedasticity Test
Heteroscedasticity is whereby you check if the residuals of a regression have changing variance. The test therefore assumes that the error terms are normally distributed. We will therefore check if the variance of the errors from a regression is dependent on the values of the independent variables. For this study, the Breusch-Pagan/Cook-Weisberg test will be used to test for heteroscedasticity.

3.5.4 Hypotheses Testing
After regressing the multivariate model, hypothesis will be tested in accordance with the specific objectives of the study. Individual hypothesis testing will be conducted whereby the effect of each and every financial management practice will be tested. This will be done using the p – values of the respective coefficients of the model’s independent variables. In
all the individual test, a two – tail test will be applied using 5 percent significance level. In addition to the individual hypothesis test, a joint hypothesis test will be conducted. This will seek to determine the how all the financial management practices in the model jointly influences SMEs’ financial performance. The joint hypothesis test will be conducted using the f-statistic test of the model and its respective p-value. It will also be a two – tail test at 5 percent significance level.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter focuses on the analysis and interpretation of the data that was collected. Specifically, the chapter covers descriptive statistics of the study variables. Further the chapter discusses the results of the findings based on the specific research objectives as presented by the ordinary least squares model results. Finally the chapter concludes with the various tests as outlined in chapter three together with the hypotheses testing.

4.2 Descriptive Statistics

The descriptive statistics for the variables are presented in table 4.1 below. The population covered is the top 100 SMEs in Kenya in the year 2017.

Table 4.1: Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Observation</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA (%)</td>
<td>100</td>
<td>23.0327</td>
<td>24.5363</td>
<td>1.36</td>
<td>42.09</td>
</tr>
<tr>
<td>Dividend payout ratio (%)</td>
<td>100</td>
<td>2.06</td>
<td>0.0182</td>
<td>0.00</td>
<td>7.23</td>
</tr>
<tr>
<td>Capital Budgeting (%)</td>
<td>100</td>
<td>0.94</td>
<td>0.2387</td>
<td>0.00</td>
<td>1</td>
</tr>
<tr>
<td>Working capital (Ksh)</td>
<td>100</td>
<td>1872517</td>
<td>6055920</td>
<td>17,600,000</td>
<td>26,000,000</td>
</tr>
<tr>
<td>Firm size (Ksh)</td>
<td>100</td>
<td>19,800,000</td>
<td>21,400,000</td>
<td>14,531,900</td>
<td>78,700,000</td>
</tr>
</tbody>
</table>

(Source: Research Findings)

From the results, the mean return on assets was found to be 23.03 percent with a standard deviation of 24.53, the minimum value of 1.36 percent and a maximum value of 42.09 percent. For the dividend policy, the mean value was found to be 2.07 percent with a
standard deviation of 0.182, the minimum value of 0.00 percent and a maximum value of 7.23 percent. With regard to the capital budgeting, results indicate 94 percent of all the SMEs engage capital budgeting activities. For the working capital, the mean value was found to be Ksh 1,872,517 with a standard deviation of 6055920, the minimum value of Ksh 17,600,000 percent and a maximum value of Ksh 26,000,000. Lastly, firm size as measured by total assets indicates that the mean value of firm is Ksh 19,800,000 with a standard deviation of 21,400,000, the minimum value of Ksh 14,531,900 and a maximum value of Ksh 78,700,000.

4.3 Heteroskedasticity Test

The Breusch-Pagan / Cook-Weisberg test for heteroskedasticity was applied in testing for the heteroskedasticity in the models. First the OLS model was estimated and the heteroskedasticity test carried out. The results in table 4.4 shows that for the OLS model, the Probability values for the respective chi square statistics for the Breusch-Godfrey LM are greater than 5 percent for both the OLS indicating absence of heteroskedasticity in the models (table 4.30).

<table>
<thead>
<tr>
<th>Breusch-Pagan / Cook-Weisberg test for heteroskedasticity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ho: Constant variance</td>
</tr>
<tr>
<td>chi2(1) = 52.18</td>
</tr>
<tr>
<td>Prob &gt; chi2 = 0.2143</td>
</tr>
</tbody>
</table>

(Source: Research Findings)
Therefore, the results of the heteroskedasticity imply that the variances across the variables of the model are constant.

### 4.4 Normality Test

To test for the fitness of the estimated model, the normality test using the model residuals was applied. The results are presented in figure 4.1.

(Source: Research Findings)

Based on the findings, the results yield a Jarque – Bera statistics of 61.92288 with a probability value of 0.000 which is less that 5 percent significance level. This implies that the residues of the model are normally distributed that thus implying that the model estimated best fits the data.

### 4.5 Correlation Analysis

The study sought to establish the relationship between the SMEs’ profitability and financial management practices. The correlation results are presented in table 4.2 as follows:
Table 4.3: Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>Working capital</th>
<th>Dividend policy</th>
<th>Capital Budgeting</th>
<th>Firm size</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working capital</td>
<td>0.0954</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend policy</td>
<td>-0.1777</td>
<td>-0.1900</td>
<td>1.0000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Budgeting</td>
<td>0.1188</td>
<td>-0.0179</td>
<td>0.0093</td>
<td>1.0000</td>
<td></td>
</tr>
<tr>
<td>Firm size</td>
<td>0.6868</td>
<td>0.1778</td>
<td>-0.1584</td>
<td>0.0740</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

From the Pearson correlation matrix results, it’s clear that working capital has a positive relationship with the firm’s return on assets implying that they move in the same direction. Similarly capital budgeting was found to have a positive relationship with the firm’s return on assets. The size of the firm was also found to be positively related to the return on asset for the SMEs. However, dividend policy was found to be negatively related to SMEs’ return on assets implying that the two move in the opposite direction. This may be explained by the fact the SMEs rarely pay divided and instead look forward towards retaining earnings as much as possible given the facing challenges they may be facing.

4.6 Discussion of the Results - Regression Model Analysis

Upon running descriptive statistics and correlation analysis, regression model was estimated. The results of regression model analysis are presented in table 4.3.
Table 4.4: Ordinary Least Square Method Results

| ROA                  | Coefficient | Std. Err. | t     | P>|t| | [95% Conf. Interval] |
|---------------------|-------------|-----------|-------|------|-------------------------------|
| Working capital     | 1.3206      | 2.5853    | 0.51  | 0.011 | -6.46466 - 3.823362          |
| Dividend policy     | -0.9199     | 1.9919    | -4.46 | 0.121 | -9.88325 - 1.95659           |
| Capital budgeting   | 1.9084      | 1.5643    | 1.22  | 0.026 | -7.52344 - 31.34019          |
| Firm size           | 0.5144      | 2.5816    | 2.52  | 0.014 | 1.37791 - 11.65093           |
| Constant            | -10.4318    | 27.5869   | -0.37 | 0.000 | -156.321 - 46.5425           |

In estimating the regression model, the multivariate model was applied with the ordinary least squares method being applied for the analysis. From the results, it is clear that working capital has a positive effect on the SME’s return on asset at 1 percent significance level. From the results, a one unit change in the working capital leads to 1.32 unit change in the SMEs’ return on assets. Therefore, when the SME’s working capital increases by one unit, return on asset increases by 1.32 unit holding other factors constant. The positive effect of working capital on financial performance seems to stress on the importance for SMEs should take into account prudence in management of their working capital. This will ensure that they do not suffer from liquidity challenges in the short run that would jeopardize their operations.

Following this findings, it is clear that sensitization of the SMEs on matters regarding working capital management of key importance. This would further go along with the investment in the accounting software that would enhance prudence management of the current assets and current liabilities of the company. This finding are in agreement with the findings by Hunjra, (2016) Jama, Samantar and Muturi (2017) Jain (2010) Zariyawati, Annuar, Hassan and Abdulrahem (2014) and Mohamed and Omar (2016) who conclude positive and significant effect of working capital on the SMEs’ financial performance.
With regard to the divided policy, results indicate that the policy had a negative effect on the SME’s return on asset. However, the effect was found not to be significant at 5 percent significance level. However, it is notable that the negative effect of divided policy on financial performance would inform the reason why SMEs have been having challenges in attracting external funding from the investors. This is because firms with the low dividend–pay-out ratio are not preferred by investors since investors perceive dividend as parts of returns on their investment.

With regard to capital budgeting decision, the empirical results posit a positive and significant effect of SMEs’ adoption of capital budgeting decision on SME’s return on asset at 1 percent significance level. Results indicate that adoption of capital budgeting decisions leads to 1.91 unit increase in the return on assets holding other factors constant. The findings conquer with the findings by Vohra and Dhillon (2014) who investigated the effects of financial management practices on financial performance of 103 small firms in India and reported a positive effect of adoption of capital budgeting activities on firm’s profitability.

This implies that the SMEs decisions regarding to investment decisions by applying payback period, internal rate of return and net present value are of significance in positively influencing SMEs’ financial performance. This finding stress on the importance of having objective project evaluations by the SMEs prior to investing in them. This is the only way the SMEs can be guaranteed to the return on their investment. This finding stress on the importance of the adoption of capital budgeting on the SMEs performance stresses on the use of a mix of different techniques of project evaluations in order to arrive as a conclusive decision informed by objectivity. It is also noteworthy that the adoption of the capital
budgeting techniques in project evaluation is also core in informing the capital expenditure of the SMEs thus.

This further enhance the efficient allocation of financial resources hence guaranteeing them optimal return possible. In addition, by adopting capital budgeting techniques, SMEs are able to mobilize for funding to fund specific projects that have been objectively evaluated hence enabling them to efficiently utilize their internal resources (equity) prudently on their day to day operations rather that locking them in the long term investment (capital investments).

Further, on the moderating variable, results indicate that SME size has a positive and significant effect on SME’s return on asset at 1 percent significance level. The findings conquer with the findings by Vohra and Dhillon (2014) investigated the effects of financial management practices on financial performance of 103 small firms in India and reported a positive effect of adoption of capital budgeting activities on firm’s profitability.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter gave a summary of the results discussed in chapter 4 after the data analysis, from which the study conclusion was presented. Lastly the chapter highlighted a number of policy implications and recommendations derived from the data analysis results and the reviewed literature.

5.2 Summary of Findings

This study sought to examine the effect of financial management practices on the financial performance of Small and Medium Enterprises in Kenya. The study focused on 100 SMEs in the KPMG survey for the year 2017. Financial performance of SMEs was measured by SME’s return on asset for the year 2017. On the other hand financial management practices were captured by working capital level, SME’s dividend policy and capital budgeting decision. Further, within the study model, the size of the SME as measured by total assets as at year 2017 was included as a moderating variable of the study.

The study adopted a quantitative research design in its analysis. The data was collected for the 2017 Top 100 SMEs in Kenya as per the 2017 KPGM survey. Within the study, financial performance of SME was measured by return on asset, working capital was measured by the difference between current assets and current liabilities, dividend policy was measured by the dividend pay – out ratio, capital budgeting decisions was measure by a dummy variable of the adoption or failure of adoption of the capital budgeting techniques.
in investment valuation. On the moderating variable, total assets of the SMEs was used to measure the size of the business enterprise.

The core findings of the study were that in terms of the relationship among the variables, the Pearson correlation matrix results reveals that working capital has a positive relationship with the firm’s return on assets implying that they move in the same direction. Similarly capital budgeting was found to have a positive relationship with the firm’s return on assets. The size of the firm was also found to be positively related to the return on asset for the SMEs. However, dividend policy was found to be negatively related to SMEs’ return on assets implying that the two move in the opposite direction. This may be explained by the fact the SMEs rarely pay divided and instead look forward towards retaining earnings as much as possible given the challenges they may be facing.

The overall results as evidenced by the empirical model estimation assert that only the working capital and the capital budgeting decision are significant in informing the SMEs’ financial performance as measured by return on assets. This is evidenced by their respective p– values of their respective coefficients. The estimation of the empirical model estimated using the OLS revealed that working capital has a positive effect on the SME’s return on asset at 1 percent significance level. With regard to the divided policy, results indicate that the policy had a negative effect on the SME’s return on asset. However, the effect was found to be insignificant. Further, the capital budgeting decision was found to have a positive and significant effect on SME’s return on asset at 1 percent significance level. Further, on the moderating variable, results indicate that SME size has a positive and significant effect on SME’s return on asset at 1 percent significance level.
5.3 Conclusion

From the results of data analyzed and the reviewed literature, it was evident that financial management practices have a positive effect on the financial performance of SMEs. This is supported by the empirical study findings of the empirical model regression. More specifically, the results indicate that working capital management will have a positive effect on the SMEs financial performance in Kenya. The findings here indicate that the cash management practices by the SMEs will have a definite effect on the financial performance in the long run. Further, we can also conclude that issues such as cash collection cycles are of importance with regards to the financial performance of the SMEs.

Therefore, from the findings SMEs in Kenya should take into account prudence in management of their working capital. This will ensure that they do not suffer from liquidity challenges in the short run that would jeopardize their operations. Following this findings, it is clear that sensitization of the SMEs on matters regarding working capital management of key importance. This would further go along with the investment in the accounting software that would enhance prudence management of the current assets and current liabilities of the company.

It is also noteworthy that given the finding on the importance of the working capital and the significant effect it has on the SMEs performance the SMEs need to effectively plan on their cash collection cycles as well as the debt payment cycle. There is great importance for the SMEs to formulate and effectively implement the policy with regard to cash collection cycles for the credit sales that matches their debt repayment cycles to their creditors. This will ensure that at no time they are faced by short term illiquidity that may prompt them to seek for short term financing such as short term overdrafts that are costly.
However, it is of great importance for the SMEs also to have a fall back plan by having reserves in form of liquid assets that they would leverage on in case of working capital challenges that arise from circumstances beyond their control.

Further, the adoption of the capital budgeting by the SMEs was also found to have a positive effect on the SMEs financial performance in Kenya. This implies that the SMEs decisions regarding to investment decisions by applying payback period, internal rate of return and net present value are of significance in positively influencing SMEs’ financial performance. This finding stress on the importance of having objective project evaluations by the SMEs prior to investing in them. This is the only way the SMEs can be guaranteed to the return on their investment.

Further, the importance of the adoption of capital budgeting on the SMEs performance stresses on the use of a mix of different techniques of project evaluations in order to arrive as a conclusive decision informed by objectivity. It is also noteworthy that the adoption of the capital budgeting techniques in project evaluation is also core in informing the capital expenditure of the SMEs thus. This further enhance the efficient allocation of financial resources hence guaranteeing them optimal return possible. In addition, by adopting capital budgeting techniques, SMEs are able to mobilize for funding to fund specific projects that have been objectively evaluated hence enabling them to efficiently utilize their internal resources (equity) prudently on their day to day operations rather that locking them in the long term investment (capital investments).
5.4 Policy Recommendations

Based on the study findings, a number of policy implications and recommendations can be fronted from the study findings. Firstly, on the working capital management, there is need for the SMEs to formulate policies that will enhance working capital management such as cash collection cycles so as to be capable of meeting their current cash liabilities using their current assets. Therefore, cash collection cycles and debt payment cycles are core in helping the SMEs manage their working capital effectively.

Further on the capital budgeting issues, there is a need for SMEs to fully adopt the capital budgeting decision especially on the capital investment activities. Therefore, there is need for the SMEs to do a detailed evaluation of the capital projects they invest in using the various methods for project evaluation under the capital budgeting decisions. This will guarantee them return on their investments in the long run which will definitely impact on their financial performance.

Thirdly, there is the need for the SMEs to develop a policy that will ensure the consensus of the working capital management and capital budgeting decisions. By this the SMEs can afford to seek for funding to finance their capital investments that are supported by objective evaluation through various techniques that would increase the chances of getting a funding. This way, the SMEs can deploy their internal financial resources in financing day – to – day operations. This will in turn work in their favor when it comes to working capital management.
5.5 Limitations of the Study

The main limitation of the study was that the study focused only on the 100 SMEs as per the KPMG 2017 survey. This was the limitation in that the SMEs in the survey change on annual terms and therefore. This implies that the findings of the study cannot be generalized for the previous years since the SMEs in the survey are different from year to year. Also given that the study focused on top 100 SMEs as per the KPMG 2017 survey, the findings of the study cannot be generalized for the rest of the SMEs given the dynamic nature of the SMEs in Kenya.

Secondly, the study was limited to the year 2017 for the analysis. This is a limitation since in the research it is not always advisable to choose a single time period. This is because a single time period can be biased and therefore the results of the study are likely to be biased. For instance, years 2017 in Kenya was an electioneering year. This is likely to affect the performance of the business enterprises at large given the political tension and the wait and see scenario held by the investors in the election period. Therefore, it is possible that the financial performance of the SMEs might have been affected by the political environment that existed in year 2017 and as such we may not scantily infer the financial performance reported by SMEs to be arising from financial practices during the study period.

Lastly the study assumed failed to take into account the difference in the sector of operation of the various SMEs included in the study. It’s evident that the industry within which the study operates plays a crucial role in the performance of the businesses operating under it. With this regard given that SMEs are dynamic in terms of the industries they operate under, there is the need to control for the industry specific effect on the financial performance of
the businesses in the empirical model. The study assumed homogeneity in the industries within which the top 100 SMEs of year 2017 operate. However, this limitation arises from the mix up of the sectors’ descriptions in the Kenya context.

### 5.6 Areas for Further Research

Based on the study findings, a number of the areas for further studies can be proposed. First, there is need for the studies on the micro issues relating to the financial management practices on the financial performance of the SMEs for specific SMEs. For instance with regard to the capital budgeting activities, there is need for the micro studies on how the actual capital budgeting activities such as Net Present Value, Payback Period or Internal Rate of Return on various projects by the SMEs impact on their financial performance. This calls for the firm – level analysis studies.

Secondly, there is need to carry out a similar study using a different measure of financial performance apart from the Return on Assets as applied in this study. This would aid in validating the findings of the study if different measures of the financial performance are used such as return on equity or net profit margin.
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