EFFECT OF FINANCIAL MANAGEMENT PRACTICES ON PERFORMANCE OF FULLY FLEDGED ISLAMIC BANKS IN KENYA

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2019
DECLARATION

I declare that this research project is my original work and has not been submitted to any other institution for the awards of a degree.

Sign ________________ Date ________________

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D63/60861/2013

This research project has been submitted with our approval as the supervisors.

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I thank my family members for the support they gave me while writing this project. I thank my supervisor Dr. Kennedy Okiro and Moderator Dr. Cyrus Iraya for their encouragement and support.
DEDICATION

I dedicate this project to my cousin, Abdi Aziz Adan.
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ABBREVIATIONS AND ACRONYMS

ANOVA  Analysis of Variance
CAs    Current Assets
CB     Capital Budgeting
CBK    Central Bank of Kenya
CLs    Current Liabilities
CS     Capital Structure
DIB    Dubai Islamic Bank
FCB    First Community Bank
FM     Financial Management
FMPs   Financial Management Practices
FP     Financial Performance
GAB    Gulf African Bank
IBs    Islamic Banks
IV     Independent Variable
KPLC   Kenya Power and Lighting Company
ROA    Return on Assets
ROE    Return on Equity
ROI    Return on Investment
SMEs   Small and Medium Enterprises
SPSS   Statistical Package for Sciences
WB     World Bank
WCM    Working Capital Management
ABSTRACT

The fully fledged Kenyan Islamic Banks (IBs) do operate in a rapidly changing and competitive banking industry. Given the fact that other conventional banks have ventured into offering of sharia compliant products, the level of competition for IBs has intensified. This increased competition has adversely affected the ability of IBs to perform. This has raised awareness on the need to adopt sound financial management practices. The study sought to determine the interaction between FMPs and the ability of the IBs to perform in financial terms. The adopted design was descriptive and 3 IBs were targeted and sampled out. Information was gathered from auxiliary sources and the analysis was conducted using SPSS tool. It was shown that FMPs have direct and significant interaction with the ability of the firms to perform financially. The study concludes that FMPs have direct and significant interaction with the ability of the firms to perform financially. It is recommended that the Kenyan IBs should improve on their capital structures for positive improvement in performance. Islamic banks should improve on their capital structures for better performance. Islamic banks should exercise caution in maintenance of current assets and current liabilities.
CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

Every form of organization whether small or large requires finance runs daily activities. For effective realization of goals, the finances in place should be prudently utilized in an organization hence the need for financial management. It is the role of finance managers to enhance the soundness of the financial system of an entity for realization of the formulated goals (Norah, Mbabazize & Shukla, 2015). Finance managers are charged with the responsibilities of making capital budgeting, investment, financing, dividend policy and working capital decisions besides assessing performance. All these responsibilities aim at ensuring that funds are available for as required for an organization to realize performance. Thus, only firms with sound financial management are able to survive in today’s environment that is faced with uncertainties and competitiveness (Getahun, 2016).

The modern portfolio theory, the prospect theory and the contingency theory provided anchorage to the study. The modern portfolio theory links risk and returns in determining establishing investment decisions and thus the value of the firm (Markowitz, 1952). Since all finance management decision entails risk on the part of the finance manager with expectation of earning a return, this justifies the applicability of this theory to the investigation. By analyzing the risk in a given investment, it would be possible for the finance manager to maximize on returns which transpires into the ability of the entity to perform. According to the contingency theory, there are several contextual factors including technology and the external surrounding that determine how well an
organization function, the design and structure of the firm and ultimately its financial management system in place (Pike, 1986). The theory further argues that there exist some given financial management practices that work best in given firms and not in other organizations (Chenhall, 2003). On the other hand, the prospect theory brings in risk in FM practices and how this influences firm’s ability to perform in financial terms.

Islamic banks (IBs) differ in the way they operate as compared to the conventional commercial banks as evidenced by prohibition of interest (riba) and profit sharing scheme. These differences imply that the financial management practices of IB is more complicated compared to those in place among conventional banks. Islamic banks unlike conventional banks have weak financial management practices because of inadequate skilled personnel, low publicity and awareness of sharia compliant products among customers (Essra'a, 2016).

1.1.1 Financial Management Practices

Financial management is the careful planning and organization of how well organization uses its resources in a most optimal way. Financial management is further seen as the way through an organization acquires financial resources to be used in generating value for shareholders. Marebo (2013) defined financial management by recognizing the key functions of the finance manager in an organization which include making of investment, financing, working capital and dividend policy decisions besides financial performance measurement and assessment. In order for an organization to attain optimal performance, these aspects of financial management should be integrated together (Demba, 2013).
Investment decisions are also called capital budgeting decision and they determine how much to be committed in investment projects that enhances the value of shareholders (Mange, 2013). Capital budgeting decisions are complex since they extent within the future of an organization and some of them involve a very heavy cash outflow. At the same time, once an organization has committed resources in an investment project, it cannot be reversed.

Financing decisions are also called capital structure decision and they determine how much the company will borrow and the proportion that would be generated from equities and retained earnings (Enekwe, 2015). Capital structure decision relates to how an organization judiciously uses debts and equity to finance investment projects. Just like the capital budgeting decision, financing decisions are also complex since they affect the overall shareholders’ wealth and the risk appetite of an entity. The evaluation of the advantages and costs of debt financing enhances the decision of leverage in the entity.

Working capital decisions involves striking a balance between current assets (CAs) and current liabilities (CLs) to ensure that the organization is liquid at all times. Working capital decisions are also risky since too much liquidity in the company would mean that resources are tied up instead of being used for investment purpose. Dividend decisions determine the amount to be used to pay shareholders for investing their resources in the company (Dumbu, 2014). Financial performance measurement and assessment entails putting in place sound system for financial tracking and reporting to ensure resources are efficiently utilized to achieve the set goals of the organization (Al-Taani, 2013). It also covers the identification and evaluation of inherent risks that are likely to affect the way businesses carry out operations.
Different measures have been adopted in determine finance management for instance, WCM is measured by taking the difference between CAs and CLs. Capital budgeting decisions are measured by the amount of capital expenditure of the firm while capital structure (CS) decisions are determined by the ratio between debts and equity (Adedeji, 2014). Liquidity is commonly measured by taking the value of CAs as a quotient of the CLs. This study used WCM, CS as well as CB as the key proxies of FMPs.

1.1.2 Financial Performance

Performance can be expressed in qualitative or quantitative terms. In order to evaluate measure performance of an organization, financial statements play an important role. Performance of an organization can be expressed in monetary as well as non-monetary terms (Brigham, Ehrhardt, Nason & Gessaroli, 2016). Financial performance determines how the firm generates revenues for paying interest, taxes, dividends and investment purpose. To measure performance in financial terms, most companies use ratios including the returns on the values of the assets, (ROA), the equities (ROE) as well as the investments (ROI) in the entity. Most of the information used to determine financial performance is extracted from books of accounts of the company (Martin, 2016).

ROE is used to determine how well an organization utilizes the equity portion of the balance sheet to generate profits. ROA on the other hand shows how effective the management team of an organization leverages on the asset portion of the balance sheet to generate revenues for shareholders ((Epstein, Buhovac & Yuthas, 2015). This study will use ROA and ROE as measures of performance.
1.1.3 Financial Management Practices and Performance

A strong financial management system is important in helping an organization to achieve better performance. This is because it results into effective utilization of the financial resources of the business. Financial management entails decision regarding how to finance investment projects, what amount to be paid to shareholders in form of dividends and what proportion of funds for financing investment projects will be sourced from debts. All these decisions are risky as they directly affect the wealth of shareholders (Gamayuni, 2018).

Mabonga and Kimani (2017) revealed that sound FM practices are important for a firm seeking to enhance it financial performance position. In another study to determine the link between FM and performance in the dairy firm, Kamande (2015) established a positive relationship link. Thus, on the basis of the empirical evidence, the interaction between FMPs and the ability of the entity to perform in financial terms is positive and this has attracted attention among scholars and academicians. Farhatali (2017) however note that there exists no consensus on this relationship existing between FM and the ability of the entity to perform.

1.1.4 Fully Fledged Islamic Banks in Kenya

Islamic banking is a concept that strongly considers the ethical values and principles of Islamic faith including offering of products that are sharia compliant. The Islamic banking strongly forbids interest (riba) and sharing of loss and profits. The Islamic banking concept is guided by key instruments of finance including musharakah, ijara, murabaha and mudarabah. All the IBs in Kenya are closely regulated by the Central Bank of Kenya (CBK). A total of three fully fledged Islamic banks are in Kenya that include
First Community Bank (FCB), Gulf African Bank (GAB) and DIB Bank Kenya Ltd. FCB and GAB were the first IBs to be licensed by CBK in the year 2007. In 2017, the third Islamic Bank, DIB Bank Kenya Ltd, was licensed by the Central Bank.

The fully fledged IBs are faced with numerous challenges including increased competition in the overall banking industry. This high competition results from the fact that other conventional banks have started offering sharia compliant products including the National Bank of Kenya (NBK). This increase in competition has adversely affected performance of these IBs as seen through market share and profitability. The CBK report (2014) indicates that about 90% of the market share is commanded by conventional banks. However, there are higher chances for increased profitability of these IBs given rapid expansion and changes in the banking sector (GAB, 2014). In order to sustain this level of performance, Kiage, Musyoka and Muturi (2015) noted that FMPs are critical. With proper FMPs, IBs would not be able to stand this high level of competition in the banking sector hence possible collapse. This therefore informs the need for the current study to determine how financial management would influence performance of IBs.

1.2 Research Problem

Financial management determines the overall risk perception and complexity of the organization which go a long way to affecting the maximization of shareholder wealth objective. As such, financial management has attracted a lot attention among academicians and scholars. Sound financial management ensures that resources of an organization are effectively utilized towards attainment of set goals and objectives and thus performance. Financial management covers a range of decisions including CB, CS, dividend allocation, WCM and liquidity that are so important in the daily operations of an
organization. These decisions are so important to finance managers of any organization striving to remain competitive and thus improve on performance (Kativa, 2013).

The fully fledged Islamic banks in Kenya operate in a rapidly changing and competitive banking industry. Given the fact that other conventional banks have ventured into offering of sharia compliant products, the level of competition for IBs has intensified. This increased competition has adversely affected performance of Islamic banks. With this, the management of IBs is left with an option of critically examining their FMPs that are in place. By improving on their financial management, Kiage et al. (2015) notes that these Islamic banks would be able to remain competitive and thus improve on their performance. If efforts are not put in place to examine financial management of IBs, conventional banks would significantly eat into the market share of these IBs and hence reducing their viability.

Literature has recently focused on FM practices and financial performance. Globally, Nkwag (2015) was keen to determine the interaction of FM and the level of accountability in Nigerian public sector. The study established that having in place sound FMPs strengthen the level of accountability in an organization. In Sri Lanka, Swarnapali and Rathnayaka (2016) studied how FM impacts on financial performance of the SMEs where a postive link was established. These studies however focused in the public and the SMEs sectors respectively and not the banking sector. This creates a contextual gap. With reference to SMEs in Uganda, Turyahebwa, Sunday and Ssekajugo (2016) evaluated how financial management influenced business performance. It was revealed that financial management practices positively influence performance of the firm. The study was
however done in the SMEs sector and not the banking industry hence creating a contextual gap.

Locally in Kenya, Mabonga and Kimani (2017) in a study assessing how financial management influences performance of SMEs in Bungoma, a positive relationship was established. The study however was done in the SME sector and not the banking industry. Kamande (2015) in an assessment of how financial management practices impacts on performance, a positive relationship was established. The study was however conducted in the dairy sector and thus did not focus in the banking sector. Among SMEs in Kiambu, Nthenge and Ringera (2017) assessed how FMPs impacted on their ability to perform and noted a positive interaction. The study however focused on SMEs sector.

Thus, as much as studies have been done to come up with the interaction between FMPs and the ability of the entity to perform, none of them has focused in the banking sector and specifically Islamic banks. Most of the studies focused in the SME sector which contextually differs from the banking sector. This created research gaps that the current sought to fill by answering the following research question; what is the interaction between FMPs and the ability of the Kenyan IBs to perform in financial terms?

1.3 Research Objective

To determine the effect of financial management practices on performance of fully fledged Islamic banks in Kenya.
1.4 Value of the Study

The study would be important to policy, practice and theory. The study would result into meaningful findings that would help policy makers including the CBK to formulate sound rules and regulations that improve on financial management of Islamic banks hence their general performance. Such policies of the CBK that would directly impact on financial management of the IBs include liquidity requirement which is an important aspect of WCM.

In practices, the study would result into findings that would guide the management of IBs to improve on their financial management practices. The study would result into recommendations that would guide the management of Islamic banks on how best to strengthen on their FM practices and how this would influence the performance of their banking institutions.

The study would open up areas for future investigations on the interaction between FMPs and the ability of the entities to perform financially. The study would facilitate future empirical studies through literature review on FM and how it interacts with performance of the firm. Through this, comparison of findings will be made possible.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter discusses the theories that form the basis of the study. The key determinants of financial performance are also discussed in details. The empirical studies are reviewed on financial management and how it influence performance. The reviewed literature is summarized to expose gaps. The conceptual framework is presented that shows the link between the study variables.

2.2 Theoretical Foundation

The key theories that guided the study are detailed below:

2.2.1 Modern Portfolio Theory

This theory was put forward by Markowitz (1952) to relate risk and return trade off in an investment. Investments are made with risks and thus before committing resources in a project, all efforts should be made to determine viability and probable risk level. In order to minimize risk exposure, the theory advocates for portfolio selection. The theory argues that risk in an investment can be reduced or rather minimized by diversification. Diversification is made possible through proper portfolio selection. A portfolio is defined as group of assets held by investors so as to minimize risk while maximizing returns.

Through holding of portfolio, an investor will have diversified the investment and thus minimizing risk exposure which ultimately maximizes returns. The way through which an investor selects and combines various assets in the portfolio form the basis of risk minimization and maximization of possible returns (Grasse, Whaley & Ihrke, 2016).
Financial management involves decisions that risky for instance the decision to invest in long term projects as well as source for additional funds to the firm. Some of these decisions for instance require an organization to commit resources in several investments (that act as assets). For optimal returns, risk return tradeoff is important which is best explained by this Modern portfolio theory (Fama & French, 2004).

2.2.2 Contingency Theory

It is Fiedler (1964) who advanced this theory to show that no single best way of leading and organizing an organization or making decisions exists, but rather, these actions are dependent (contingent) to the forces of the environment (both internal and external). The theory argues that contingent factors (the culture, the forces of the environment, culture) all influence how the organization is to be designed and function (Woods, 2009). One of the structures in an organization is the financial management system. Hence, the design and functioning of the FM system is contingent on other factors within an organization. Thus, all the activities carried out within financial management are contingent on other factors (Lee, Cheng & Chong, 2016). The theory provides the link between FM practices in firms.

2.2.3 Prospect Theory

Tversky and Kahneman (1979) came up with this theory and it argues that some decisions in an organization including financial management usually involve an element of risk. This is because such decision entails a balance between competing alternatives. The risk comes in because some alternatives considered have no predetermined or certain outcomes.
This theory is descriptive in nature since it strives to offer a description of real life issues rather than the decisions that are optimal in some ways (Barberis, Mukherjee & Wang, 2016). The theory argues that before any financial decision is made, an individual should first determine and consider the risk to be involved (Ebert & Strack, 2015). At the same time, the owners of the firms should make decisions as informed by some level and degree of expertise which call for the need of financial management practices to be in place. Through financial management practices, an organization will be better placed to effectively manage resources for improved performance (Abdellaoui et al., 2016). Therefore, the overall implication of this theory is that through proper understanding of financial management practices, an entity is able to minimize the possible risk exposure and thus chancers of improving financial performance (Ingersoll, 2016).

2.3 Determinants of Financial Performance of Islamic Banks

This section reviews literature on determinants of financial performance of IBs.

2.3.1 Liquidity

Liquidity is how well an organization has the ability to attain its short term obligations. Liquidity is closely related with the concept of working capital which is the difference between CAs and CLs of the firm. The main reasons for analyzing and determining the working capital of the business is to ensure liquidity of the business. Working capital and liquidity management is a risky decision because it determines the going concern assumption of the firm. Too much liquidity would mean that the firm has greater tied up capital that could otherwise be spent in other viable investment projects for increased value of the firm (Afande, 2015).
Kirui (2013) in a study to determine the interaction between WCM practices and financial performance, a case of sugar cane growing firms was used. The study noted that in most sugar cane growing firms have in place the conservative WCM which adversely affect performance. Mwangi et al. (2014) analyzed the link between WCM and the ability of Kenyan listed entities to perform. It was noted that there are two types of financing policies; aggressive and conservative and all these policies significantly determine performance of the firm.

2.3.2 Capital Structure

The CS of the firm is how well an organization balances the debts and equity to finance investment projects. This is also a risk activity of the financial management because it determines whether the firm would be bankrupt and thus get dissolved or continue to operate. In particular, the use of debts is beneficial to the firm since its helps in maximizing the shareholder wealth of the entity. Debts in the capital structure also act as disciplinary measure to the management to ensure they undertake projects that add value to the firm for servicing of the debts (Afonso, José, Fátima & André 2017).

Too much debts in the CS of an entity is however risky because in the event that the company fails to repay, it can result into bankruptcy proceedings that would be detrimental to the business. Karanja (2014) examined the interaction between CS and the ability of the entity to perform in financial terms where a significant interaction was noted. Chepkemoi (2013) used a case of SMEs to bring out the interaction between CS and their ability to perform and noted an inverse interaction.
2.3.3 Capital Budgeting Decisions

This is also called investment decision and they determine the amount that the business set aside to invest in viable projects. A number of activities are undertaken during capital budgeting decision including coming up with project proposals, carrying out project appraisal to determining the most viable project and then commitment of resources in the identified project. The projects that the firm will have invested in earn returns which maximize the wealth of shareholders (Gupta, 2016).

Verma and Roopali (2014) in an assessment of capital budgeting that are adopted in the Indian context, information from auxiliary sources was used. It was revealed that in order to make capital budgeting decisions, both discounted and non-discounted techniques are employed. Puwanenthiren (2016) in Sri Lanka assessed the link between capital budgeting and firm performance. Capital budgeting was identified as a critical factors determining performance of the firm.

2.3.4 Size of the Firm

Firms with relatively larger size are deemed to be more stable in any given industry and thus generate more profits. On the other hand, small firms have limited market opportunities and their ability to generate more profits is limited (Fowowe, 2017). Large firms are usually associated with economies of scale including ability to access capital resources and trade discounts. This gives them an advantage over smaller firms. Thus, a positive relationship is expected by the size of the firm and financial performance (Vithessonthi & Tongurai, 2015).
Size can be operationalized in different ways including sales revenue, asset base, employee base as well as the overall market share. The common measure of firm size is determining the natural logarithm of the total assets that are in place in an organization. Assets in this context include both current as well as the non-current facilities like building and machineries (Storey, Keasey, Watson & Wynarczyk, 2016).

2.4 Empirical Literature Review

Jordaan (2018) analyzed FM in the context of the public sector. It was revealed that key measures and steps of improving efficiency in FM in the public sector include capacity building efforts and training. Iskandar, Lasa and Abu-Hassan (2014) did a study to link FM in the public sector context. The study was done in Malaysian public sector. A total number of 80 internal audit units of government agencies were surveyed. The study revealed that the degree of cooperation among auditors and the audit committee, the size of the audit team and the skills set of auditors are key in increasing effectiveness in public FM. The study also focused in the public sector and it was done in Malaysia and not in Kenyan context creating gap.

In India, Altaf and Shah (2017) looked at WCM and the ability of an entity to perform. A total of 437 firms were studied. The study established that WCM significantly influences the ability of an entity to perform. The study however was done in Indian context and among non-financial firms and not commercial banks. This creates contextual gaps. Among manufacturing firms in Spain, Herranz, Estévez, Oliva and Dé (2017) looked at the relationship existing between FM and performance. Data was sourced from secondary materials over a period from 2008 all through to 2012. To analyzed data, principal
component analysis was used. It was shown that forecasting and benchmarking financial performance results into critical information for improved performance of the firm.

Locally in Kenya, Simon and Mohamed (2017) was keen to bring out the interaction between FMPs and the ability of the entity to perform. A case of Mombasa County was used. Among the study variables included financial planning, sourcing, allocation and control of funds. A total of 200 respondents were targeted out of which 60 were sampled out. The findings of the study showed that FM positively influences performance. This study was done in the public sector and thus failed to link the FM in the banking sector.

Kamwana and (2014) focused on FM and its interaction with ability of the enterprises to perform while focusing on projects funded by World Bank. Specifically, the study used a case of Kenya Power and Lightning Company projects. A total of 500 staff of KPLC was targeted. It was shown that FM significantly influences performance. Mabonga and Kimani (2017) looked at the link between FM practices and performance with reference to Microfinance Institutions. In total, 23 MFIs were studied. The study showed that FM significantly influences performance. The study was however done in MFIs and not Islamic banks.

Nthenge, Daniel and Ringera, Japhet (2017) looked at FM practiced and performance. A case of SMEs in Kiambu County was used. The variables of the study were WCM, investment and financing decisions. The design used was descriptive. A direct and significant interaction was noted between FM and the ability of the firm to perform. Njenga, Omondi and Omete (2014) did a study to determine the influence of FM and the ability of the entity to perform with key emphasis on the public sector. The adopted
design was descriptive. In total, 42 respondents were sampled and interviewed. The period of collecting data was 2007 all through to 2012. The study established that FM significantly influences performance.

Fwamba (2018) looked at the influence of FM on performance with emphasis on companies that manufacture sugar. The variables of the study were CS and liquidity. The theories of the study were; agency theory, liquidity preference theory and Modigliani and Miller theory. The design adopted was descriptive and 12 manufacturing firms were sampled. The study revealed the FM significantly influences performance of the firm.

Nyongesa (2017) looked at the interaction between FM and performance while focusing on the insurance firms. The variables of the study were; working capital, capital budgeting, claims management policies, corporate governance. In total, 49 insurance firms were covered. The gathering of information was on a period from 2011 all through to 2015. The design adopted was correlational. A significant interaction between the study variables was noted.
2.5 Summary of the Literature Review and Research Gaps

Table 2.1 summarizes the reviewed literature showing research gaps.

Table 2.1: Summary of the Literature Review and Research Gaps

<table>
<thead>
<tr>
<th>Author</th>
<th>Topic</th>
<th>Key Findings</th>
<th>Research Gaps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iskandar, Lasa and Abu-Hassan (2014)</td>
<td>Financial management in the context of the public sector</td>
<td>The size of the audit team and the skills set of auditors are key in increasing effectiveness in public financial management</td>
<td>The study was not the Islamic banks</td>
</tr>
<tr>
<td>Altaf and Shah (2017)</td>
<td>WCM and performance of the firm</td>
<td>WCM significantly influences performance of the firm</td>
<td>It was conducted in India and not in Kenya hence resulting into contextual gap</td>
</tr>
<tr>
<td>Herranz, Estévez, Oliva and Dá (2017)</td>
<td>Relationship existing between financial management and performance.</td>
<td>Forecasting and benchmarking financial performance results into critical information for improved performance of the firm</td>
<td>The context of the study was Spain and not Kenya.</td>
</tr>
<tr>
<td>Simon and Mohamed (2017)</td>
<td>the influence on financial management practices on performance</td>
<td>Financial management positively influences performance</td>
<td>The study was done the public sector (Mombasa County) and thus failed to cover IBs</td>
</tr>
<tr>
<td>Kanyama and (2014)</td>
<td>influence of financial management on performance</td>
<td>Financial management significantly influences performance</td>
<td>The study focused on WB funded projects and thus did not cover IBs</td>
</tr>
<tr>
<td>Nyongesa (2017)</td>
<td>the interaction between FM and performance while focusing on the insurance firms</td>
<td>Financial management significantly influences performance</td>
<td>The study covered insurance firms and not the IBs</td>
</tr>
</tbody>
</table>
2.6 Conceptual Framework

Consider Figure 2.1 showing the study variables

**Independent Variable**

**Financial Management Practices**
- Capital Budgeting
- Capital Structure
- Liquidity

**Control Variable**
- Firm Size

**Dependent Variable**

**Financial Performance**
- Return on Assets

Figure 2.1: Conceptual Framework

Source; Researcher (2019)

From Figure 2.1, it is clear that financial risk management practices are the IVs, firm size is the control and FP is the dependent study variable.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter pays focus on the adopted study design and the targeted respondents. The means of gathering information and how it was processed are also well detailed in this chapter. The manner in which the gathered information was presented is also well illustrated.

3.2 Research Design

The key types of study designs are: descriptive, exploratory and causal designs.

A cross sectional descriptive research design was used in an attempt to attain the objectives. The design was cross sectional because it cut across three IBs in Kenya. The descriptive design according to Kothari (2004) reports things as they are in their original state. A descriptive design was appropriate in determining the financial management among IBs and how it influences on their performance.

3.3 Population of the Study

The term population refers to whole list of items or people that are of homogenous attributes and which are of greater interest to the researcher. A total of 3 fully fledged IBs in Kenya (FCB, GAB and DIB respectively) were targeted (appendices I). All these banking entities were censured.
3.4 Data Collection

The term data refers to raw facts or information that has not been processed into meaningful observations. Data for the study was obtained from auxiliary sources with aid of data collection sheets over a time frame from 2014-2018. This information was obtained on a quarterly basis. The timeframe was selected because it was most current besides the availability of data.

3.5 Data Analysis

In order to make the collected data meaningful, analysis was done. Before analysis, coding was carried out where the data was entered in SPSS. To analyze data, means, standard deviations and regressions were used.

3.5.1 Analytical Model Specification

The model is as specified below;

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon \]

Where \( Y \) is = Financial Performance (ROA=Total Assets/Net Income)

\( X_1 = \) Capital Budgeting (Natural logarithm of the differences in proceeds from sale and purchase of assets)

\( X_2 = \) Capital Structure (Debts/Equity)

\( X_3 = \) Liquidity (Current assets/Current Liabilities)

\( X_4 = \) Firm Size (Natural Logarithm of Total Assets)
The operationalization of the variables is shown in Table 3.1.

Table 3.1: Operationalization of Variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Operationalization</th>
<th>Type of Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent ROA</td>
<td>The proportion of revenues generated from the assets in place</td>
<td>Total Assets/ Net Income</td>
<td>• Descriptive analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regression analysis</td>
</tr>
<tr>
<td>Independent capital budgeting</td>
<td>Decisions regarding expansion and contraction of assets in the firm</td>
<td>Proceeds from sale of assets-purchase of new assets</td>
<td>• Descriptive analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regression analysis</td>
</tr>
<tr>
<td>Independent capital structure</td>
<td>The debts and equities used to finance investment projects</td>
<td>Debts/ Equity</td>
<td>• Descriptive analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regression analysis</td>
</tr>
<tr>
<td>Independent liquidity</td>
<td>How the short term obligations of the firm are realized when they are due</td>
<td>Current assets/current liabilities</td>
<td>• Descriptive analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regression analysis</td>
</tr>
<tr>
<td>Control variable firm size</td>
<td>It refers to the scope of operations of the firm</td>
<td>Natural logarithm of total assets</td>
<td>• Descriptive analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regression analysis</td>
</tr>
</tbody>
</table>

3.5.2 Test of Significance

A comparison was made between the p-values and 0.05. P values less than 0.05 implied significance. To determine the overall fitness of the regression model, an F test was carried out by comparing the value of F calculated and F critical through the Analysis of Variance (ANOVA).
3.5.3 Diagnostic Tests

Before regressing financial management against performance, the researcher carried out normality tests, multicollinearity test, heteroskedasticity, and autocorrelation and Stationarity tests. Normality test was done to ensure that the data set had a distribution that was normal. It was carried out using normal PP plots. Multicollinearity test was done using VIF values while Scatter plots were used to determine the presence of heteroskedasticity. Autocorrelation was used to establish whether there is serial correlation in the data set and Durbin Watson test was used. The values of Durbin Watson (d) that is closer to 2 show absence of Autocorrelation in the data set.
CHAPTER FOUR
RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

The analysis of the gathered data is well detailed in this chapter. Information for the study was obtained on a quarterly basis over a five year time horizon (2014-2018). The period was ideal because it was as current as possible and most of the data was available from Central Bank reports and the financial statements of the respective institutions. From the 3 banking institutions that were targeted by the study, complete data was obtained from 2 banks. Thus, the value of n was (4*5*2) which is equivalent to 40 data points.

4.2 Descriptive Statistics

Consider Table 4.1 detailing the results of means as well as standard deviations.

<table>
<thead>
<tr>
<th>Table 4.1: Descriptive Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>-----------------------------------</td>
</tr>
<tr>
<td>Return on Assets</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>.12</td>
</tr>
<tr>
<td>.75</td>
</tr>
<tr>
<td>.38</td>
</tr>
<tr>
<td>.219</td>
</tr>
<tr>
<td>Capital Structure</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>1.94</td>
</tr>
<tr>
<td>9.39</td>
</tr>
<tr>
<td>4.33</td>
</tr>
<tr>
<td>2.55</td>
</tr>
<tr>
<td>Capital Budgeting</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>3.28</td>
</tr>
<tr>
<td>4.12</td>
</tr>
<tr>
<td>3.70</td>
</tr>
<tr>
<td>0.315</td>
</tr>
<tr>
<td>Liquidity</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>3.28</td>
</tr>
<tr>
<td>4.70</td>
</tr>
<tr>
<td>3.98</td>
</tr>
<tr>
<td>0.409</td>
</tr>
<tr>
<td>Firm Size</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>3.47</td>
</tr>
<tr>
<td>9.18</td>
</tr>
<tr>
<td>5.38</td>
</tr>
<tr>
<td>2.104</td>
</tr>
</tbody>
</table>

Source: Research Data (2019)

The findings in Table 4.1 indicates that the average ROA was 0.38 SD=0.219, capital structure on average was at 4.33 with SD= 2.55, capital budgeting had an average of 3.70 with SD= 0.315, liquidity as an average was at 3.98 with SD= 0.409 and firm size was at an average of 5.38 with SD= 2.104.
Thus, most Islamic banks generate 38% of their net profits using their assets in place. Secondly, there was higher variation and spread (fluctuations) in capital structure and firm size among Islamic banks as shown by higher values of standard deviations.

4.3 Trend Analysis

The subsequent sections detail the results of the trend analysis on the variables used in the study.

4.3.1 Return on Assets

According to Martin (2016), financial performance determines how the firm generates revenues for paying interest, taxes, dividends and investment purpose and to measure performance in financial terms, most companies use ratios including the returns on the value of the assets (ROA), equities (ROE) as well as the investments of the firm (ROI). ROA was used a proxy of FM in the current investigation and Figure 4.1 gives the trend analysis results.

![Figure 4.1: Return on Assets](image_url)
From Figure 4.1, the movement in return on assets across the study period was erratic. This means that Islamic banks have been experiencing fluctuations in their financial performance. This could be attributed to a number of factors including high level of competition in the entire banking sector where most banks are now offering Islamic banking services. The finding is collaborated by Essra'a (2016) who indicates that Islamic banks unlike conventional banks have weak financial management practices because of inadequate skilled personnel, low publicity and awareness of sharia compliant products among customers.

4.3.2 Capital Structure
Enekwe (2015) argues that financing decisions are also called capital structure decision and they determine how much the company will borrow and the proportion that would be generated from equities and retained earnings and that capital structure decision relates to how an organization judiciously uses debts and equity to finance investment projects with the aim of maximizing the wealth of the shareholders while minimizing the cost of capital. In this study, capital structure was operationalized as the ratio of debts against equities and the trend is illustrated in Figure 4.2.
The findings in Figure 4.2 indicate that generally, there was fluctuation in capital budgeting among Islamic banks. This fluctuation could be attributed to differences in use of debts and equities in financing their projects. In similar terms, Afonso, José, Fátima and André (2017) opine that the CS of the firm is how well an organization balances the debts and equity to finance investment projects.

4.3.3 Capital Budgeting

Mange (2013) indicates that investment decisions are also called capital budgeting decision and they determine how much to be committed in investment projects that enhances the value of shareholders and that capital budgeting decisions are complex since they extent within the future of an organization and some of them involve a very heavy cash outflow. In this study, capital budgeting decisions were measured by natural
logarithm of the differences in proceeds from sale and purchase of assets. Consider Figure 4.3.

**Figure 4.3: Capital Budgeting**

The findings in Figure 4.3 indicate that on average, the movement in capital budgeting among IBs was erratic. This could be explained the fact that as some of the IBs dispose of their assets, others acquire new ones and this continuous in cycle hence bringing about fluctuations.

**4.3.4 Liquidity**

Afande (2015) considers liquidity as how well an organization is able to meet its short term obligations and that it has a close link with WC which is the difference between CA and CLs of the entity. The study therefore operationalized liquidity as a quotient of CA and CLs. Consider Figure 4.4.
The findings in Figure 4.4 indicate that liquidity among Islamic banks across the study period moved with an increasing trend. In other words, most of the IBs had sufficient current assets to meet the current liabilities as when and they were due. Afande (2015) noted that too much liquidity would mean that the firm has greater tied up capital that could otherwise be spent in other viable investment projects for increased value of the firm.

Figure 4.4: Liquidity
4.3.5 Firm Size

The findings of the trend analysis of the size of the firm are as presented in Figure 4.5.

![Figure 4.5: Firm Size](image)

As indicated in Figure 4.5, most of the Islamic banks recorded a consistent increase in their sizes. This could be supported by the heavy investment in opening of more branches by the banking entities across the country.

4.4 Diagnostic Tests

Diagnostic tests were carried out to determine whether the data set used in the study was well modeled for carrying out inferential statistical analysis. Table 4.2 reports the VIF results for determining multicollinearity.
The findings in Table 4.2 indicate the values of VIF; where capital structure had the highest value at 6.539 while firm size had the lowest value at 1.395. Thus, all the values of VIF are within the threshold of 1-10; this means that the data set did not have multicollinearity. In order to test for autocorrelation, the value of Durbin Watson Statistic was used. The findings are reported in Table 4.3.

<table>
<thead>
<tr>
<th>Model</th>
<th>Durbin-Watson</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.055^a</td>
</tr>
</tbody>
</table>

The findings in Table 4.3 indicate that the value of Durbin Watson Statistic as used in testing for multicollinearity was 2.055; hence no serial correlation was evident in the data. In order to test for normality, the study used the values of Skewness and Kurtosis and the PP Plots as indicated in Table 4.4 and Figure 4.6 respectively.
Table 4.4: Skewness and Kurtosis

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Skewness Statistic</th>
<th>Std. Error</th>
<th>Kurtosis Statistic</th>
<th>Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td>40</td>
<td>.512</td>
<td>.687</td>
<td>-1.160</td>
<td>1.334</td>
</tr>
<tr>
<td>Capital Structure</td>
<td>40</td>
<td>1.203</td>
<td>.687</td>
<td>.323</td>
<td>1.334</td>
</tr>
<tr>
<td>Capital Budgeting</td>
<td>40</td>
<td>-.216</td>
<td>.687</td>
<td>-1.803</td>
<td>1.334</td>
</tr>
<tr>
<td>Liquidity</td>
<td>40</td>
<td>-.384</td>
<td>.687</td>
<td>.635</td>
<td>1.334</td>
</tr>
<tr>
<td>Firm Size</td>
<td>40</td>
<td>.993</td>
<td>.687</td>
<td>-.758</td>
<td>1.334</td>
</tr>
</tbody>
</table>

The information in Table 4.4 is further represented in Figure 4.6 below.

![Normal P-P Plot of Regression Standardized Residual](image)

Dependent Variable: Return on Assets

Figure 4.6: PP Plot

From Table 4.4 and Figure 4.6 above, it is clear that the data set used in the study was normally distributed.
4.5 Regression Results

The interaction between FMPs and the ability of the firm to perform in financial terms was brought out using regression analysis as detailed in subsequent sections.

4.5.1 Model Summary

Consider Table 4.5 as the study model summary

Table 4.5: 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>.944a</td>
<td>.891</td>
<td>.804</td>
<td>.09699</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Firm Size, Capital Budgeting, Liquidity, Capital Structure

Table 4.5 gives adjusted R square as 0.804; implying that 80.4% variation in the ability of the firm to perform in financial terms is explained by variation in FMPs.

4.5.2 Analysis of Variance

Consider the ANOVA results illustrated in Table 4.6.

Table 4.6: Analysis of Variance

<table>
<thead>
<tr>
<th></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>.385</td>
<td>4</td>
<td>.09625</td>
<td>71.828</td>
<td>.013b</td>
</tr>
<tr>
<td>Residual</td>
<td>.047</td>
<td>35</td>
<td>.00134</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>.432</strong></td>
<td><strong>39</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return on Assets
b. Predictors: (Constant), Firm Size, Capital Budgeting, Liquidity, Capital Structure

The findings in Table 4.6 indicate that the value of F calculated is 71.828; this value is large enough and thus shows that the model of the study was okay for use.
4.5.3 Regression Coefficients and Significance

Consider Table 4.7 that gives the results on beta coefficients and significance.

Table 4.7: Regression Coefficients

<table>
<thead>
<tr>
<th>Coefficients</th>
<th>Unstandardized</th>
<th>Standardized</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>-2.231</td>
<td>-2.056</td>
</tr>
<tr>
<td>Capital Structure</td>
<td>.121</td>
<td>.247</td>
</tr>
<tr>
<td>Capital Budgeting</td>
<td>.575</td>
<td>1.079</td>
</tr>
<tr>
<td>Liquidity</td>
<td>-.369</td>
<td>-.128</td>
</tr>
<tr>
<td>Firm Size</td>
<td>.393</td>
<td>.033</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B</th>
<th>Std. Error</th>
<th>Beta</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>-.2231</td>
<td>1.085</td>
<td>-.2056</td>
<td>.000</td>
<td></td>
</tr>
<tr>
<td>.121</td>
<td>.032</td>
<td>.247</td>
<td>3.781</td>
<td>.011</td>
</tr>
<tr>
<td>.575</td>
<td>.24</td>
<td>1.079</td>
<td>2.396</td>
<td>.002</td>
</tr>
<tr>
<td>-.369</td>
<td>.115</td>
<td>-.128</td>
<td>-3.209</td>
<td>.000</td>
</tr>
<tr>
<td>.393</td>
<td>.118</td>
<td>.033</td>
<td>3.331</td>
<td>.000</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return on Assets

From Table 4.7, the following regression equation is modeled:

\[ Y = -2.231 + .121X_1 + .575X_2 - .369X_3 + .393X_4 + \varepsilon \]

Where \( Y \) is = Financial Performance (ROA=Total Assets/Net Income)

\( X_1 = \) Capital Budgeting

\( X_2 = \) Capital Structure

\( X_3 = \) Liquidity

\( X_4 = \) Firm Size

At 5% level of significance, the study established that capital budgeting (\( \beta=0.121, p<0.05 \)) is positively and significantly connected with the ability of the entity to perform in financial terms. Capital structure (\( \beta=0.575, p<0.05 \)) is positively and significantly
connected with the ability of the entity to perform in financial terms. Liquidity ($\beta=-.369$, $p<0.05$) is negatively and significantly connected with the ability of the entity to perform in financial terms. Firm size ($\beta=.393$, $p<0.05$) is positively and significantly connected with the ability of the entity to perform in financial terms.

### 4.6 Discussion of the Findings

The study established that capital budgeting ($\beta=0.121$, $p<0.05$) is positively and significantly connected with the ability of the entity to perform in financial terms. The finding concurs with Puwanenthiren (2016) who assessed the link between capital budgeting and firm performance and identified capital budgeting as a critical factor determining performance of the firm. Verma and Roopali (2014) in an assessment of capital budgeting that are adopted in the Indian context, it was revealed that in order to make capital budgeting decisions, both discounted and non-discounted techniques are employed.

Capital structure ($\beta=0.575$, $p<0.05$) is positively and significantly connected with the ability of the entity to perform in financial terms. Similarly, Karanja (2014) noted that a significant interaction exist between FM and the ability of the entity to perform. The positive relationship between CS and FP imply that increase in CS would improve FP. The findings contradict Chepkemoi (2013) who analyzed the link between CS and FP in the SMEs context and revealed a negative link between the variables.

Liquidity ($\beta=-.369$, $p<0.05$) is negatively and significantly connected with the ability of the entity to perform in financial terms. The finding is consistent with Mwangi et al. (2014) noted that there are two types of financing policies; aggressive and conservative
and all these policies significantly determine performance of the firm. Similarly, Kirui (2013) noted that in most sugar cane growing firms have in place the conservative WCM which adversely affect performance.

Firm size ($\beta=.393$, $p<0.05$) is positively and significantly connected with the ability of the entity to perform in financial terms. Firms with relatively larger size are deemed to be more stable in any given industry and thus generate more profits. On the other hand, small firms have limited market opportunities and their ability to generate more profits is limited (Fowowe, 2017).
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
The analyzed findings are summarized in this chapter with the key conclusions from the same. The chapter also makes recommendations while pointing out the limiting factors as well as the areas that require further inquiry in statistical terms.

5.2 Summary of the Findings
From descriptive statistics, the study established that most Islamic banks generate 38% of their net profits using their assets in place. There was higher variation and spread (fluctuations) in capital structure and firm size among Islamic banks as shown by higher values of standard deviations.

The findings of trend analysis showed that the movement in return on assets across the study period was erratic. This means that Islamic banks have been experiencing fluctuations in their financial performance. Generally, there was fluctuation in capital budgeting among Islamic banks. On average, the movement in capital budgeting among IBs was erratic. Liquidity among Islamic banks across the study period moved with an increasing trend. In other words, most of the IBs had sufficient current assets to meet the current liabilities as when and they were due. Most of the Islamic banks recorded a consistent increase in their sizes.

From the results, all the results from diagnostic tests were within the required thresholds. From the regression findings, the values of R, R square and adjusted R square were 0.944, 0.891 and 0.804 respectively. The ANOVA gave an okay for use of the study
model in analysis. At 5% level of significance, the study established that CB is positively and significantly connected with the ability of the entity to perform in financial terms. CS is positively and significantly connected with the ability of the entity to perform in financial terms. Liquidity is negatively and significantly connected with the ability of the entity to perform in financial terms. Firm size is positively and significantly connected with the ability of the entity to perform in financial terms.

5.3 Conclusion
Thus, capital budgeting is positively and significantly connected with the ability of the entity to perform in financial terms. CS is positively and significantly connected with the ability of the entity to perform in financial terms. Liquidity is negatively and significantly connected with the ability of the entity to perform in financial terms. Firm size is positively and significantly connected with the ability of the entity to perform in financial terms. Thus, financial management practices are positively and significantly connected with the ability of the entity to perform in financial terms.

5.4 Recommendations of the Study
Capital budgeting and FP were found to be directly and significantly connected. Hence, IBs in Kenya should improve on their capital structures for positive improvement in performance.

Capital structure also had positive and significant effect on FP of Islamic banks. Therefore, the study recommends that Islamic banks should improve on their capital structures for better performance.
Liquidity and FP were found to be inversely connected. Thus, IBs should exercise caution in maintenance of current assets and current liabilities.

5.5 Limitations of the Study
Three Islamic banks (Appendix I) were covered in this investigation. Information was largely obtained from secondary sources on a quarterly basis covering a time horizon from 2014 all through 2018. The inquiry concentrated on bringing out the interaction between FMPs and FP. The variables in the study included capital structure, capital budgeting, liquidity as well as firm size.

5.6 Areas for Further Research
In the current investigation, FMPs were found to have an explanation of only 80.4% variability in FP of an entity. Thus, apart from financial management which this study focused on, other factors are in place with an influence on how firms perform. The study also concentrated on Islamic banks, future studies should cover conventional banks as well.
REFERENCES


APPENDICES

APPENDIX I: FLEGDED ISLAMIC BANKS IN KENYA

1. First Community Bank (FCB)

2. Gulf African Bank (GAB)

3. Dubai Islamic Bank (DIB)

Source; CBK (2018)
## APPENDIX II: DATA COLLECTION SHEET

<table>
<thead>
<tr>
<th>S/No</th>
<th>Year</th>
<th>Total Assets</th>
<th>Total Equity</th>
<th>Net Income</th>
<th>Proceeds from Sale of assets</th>
<th>Purchase of new assets</th>
<th>Debts</th>
<th>Current Assets</th>
<th>Current Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2014</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>2015</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>2016</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>2017</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>2018</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### APPENDIX III: RAW DATA

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank</th>
<th>ROA</th>
<th>Capital Structure</th>
<th>Capital Budgeting</th>
<th>Liquidity</th>
<th>Firm Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>FCB</td>
<td>0.017691</td>
<td>0.942149</td>
<td>3.510947</td>
<td>4.007107</td>
<td>4.053271</td>
</tr>
<tr>
<td>2014</td>
<td>DIB</td>
<td>0.005466</td>
<td>0.976834</td>
<td>3.370698</td>
<td>3.276692</td>
<td>3.466423</td>
</tr>
<tr>
<td>2015</td>
<td>FCB</td>
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