Influence of Financial Management Practices on the Performance of Micro and Small Enterprises in Kenya

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ABSTRACT

Micro and Small Enterprises (MSEs) are seen as a driving force for the promotion of an economy and they contribute immensely to the economic development of any country. Lack of knowledge of financial management combined with the uncertainty of the business environment often leads MSEs to serious problems regarding financial performances. The main objective of this study was to explore the influence of financial management practices on the performance of Micro and Small Enterprises in Kenya. The study was guided by the following objectives: financial innovations, investing activities, risk management practices and working capital management. Since the MSE population is quite high, the target population for this study was estimated at over 10000 management staff from selected MSEs in Nairobi. Simple random sampling technique was employed to select the sample of 95 respondents. Primary data was collected using a self-administered questionnaire. The questionnaire was semi-structured, having both open-ended and closed-ended questions. Data was presented in tables, charts and graphs. Content analysis was used to analyze qualitative data. A multivariate regression model was applied to determine the relative importance of each of the four variables with respect to performance of MSEs. The study found out that financial innovations influence the performance of Micro and Small Enterprises in Kenya to a very great extent. The study established that the reason for innovation in an organization is to make profit. The study found out that Investing can be described as the redirection of resources from being consumed today to creating benefits in the future and that Development of an effective business support system is also a key condition for the success of investment capacity building Further respondents strongly agreed that investing requires business support agencies which have a demonstrated capability of penetrating the MSE sector. This study concludes that financial innovations influence the performance of Micro and Small Enterprises in Kenya to a very great extent and that the reason for innovation in an organization is to make profit. Further the study concludes that Risk has become part of a strategic component of the modern organization’s survival and development. Finally the study concludes that there’s a statistical significant between working capital and firm performance and that there is need for a tradeoff between receivables and holding inventory if the firm is to attain the required profits.The study recommends the owner/managers of small and medium sized enterprises should embrace financial innovations in order to generate long term stability and for the firm to have competences. The study also recommends that it is essential for small and medium sized enterprises to invest so that investments can grow to fight against inflation and future uncertainties and that the owner/managers should develop an effective business support system is also a key condition for the success of investment capacity building. This study has analyzed the influence of financial management practices on the performance of Micro and Small Enterprises in Kenya. There is need to find out the challenges facing Micro and Small Enterprises in Kenya.

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

Introduction

The contribution of MSEs is more than double that of the large manufacturing sector, which stands at 7% of the GDP (Republic of Kenya, 2006). Overall, MSEs create 75% of all new jobs. Estimates show that, in the year 2005, the SME sector employed about 5,086,400 people, up from 4624400 in 2003 (Migiro, & Wallis 2006). This was an increase of 462,000 persons and consisted of 74.2% of total national employment. The average income of enterprises surveyed was about Kshs.6,000 per month, or more than two times 100 higher than the minimum legal monthly wage for unskilled employees, which in 2006 was Kshs.2,536. The share of the MSE sector's contribution to GDP was estimated at18.4 percent. It is recognized that MSEs constitute a significant portion of the Kenyan private sector. They participate in overall investment, in production of goods and services, in taking risks, in perceiving and utilizing new economic opportunities and in developing business in the economy. In Kenya, MSEs have contributed to the extension of price-based signals into areas such as urban service delivery; garbage collection, urban transport, water distribution and manufacturing of a wide range of domestic and commercial appliances (ILO, 2002).

The significance of Kenya's micro and small enterprises (MSE) activity has continued to grow since the sector was first brought to the limelight in 1972. The ILO provided the basis for the study of MSE in Kenya under the informal sector. In Kenya, it is now widely recognized that the promotion of the MSE sector is a viable and dynamic strategy for achieving national goals, including employment creation, poverty alleviation and the balanced development between sectors and sub-sectors. The findings of the 2003 MSE Baseline Survey underscored the important role that MSEs play in Kenya's development process, particularly in the context of generating employment and income opportunities for majority of poor people throughout the country. Indeed, the MSE sector provides employment for substantially more people than does the formal sector (Central Bureau of Statistics, 2002).

Statement of the Problem

The influence of financial management practices on performance is one significant topic in the field of entrepreneurship and MSE sector development as evidenced by an increasing number of publications and studies on the topic (World Bank, 2013). According to Ahmad et al. (2011), approximately 80% to 90% of SMEs fail within 5-10 years. According to the Kenya Economic Survey 2013, the performance of Kenyan MSEs is weak as evidenced by the decline in growth rate from 5.4% in 2011 to a 4.3% in 2013. Such decline in performance leads to unemployment in Kenya which as a result leads to social injustices and crime (RoK, 2013). Furthermore, the ways to address bimodial distribution of firms where 59% are MSEs, 16% medium firms, and 23% large firms is still an empirical matter (KPMG, 2012). Poor business performance in the MSE sector has for long remained unexplained most especially in the third-world countries perspective where the Medium and Small Enterprises occupy the large part of the economy (Brigham, 2002). However, studies from developed nations find financial management practices to contribute immensely to MSEs poor business performance.

Previous studies which have studied MSEs among which Tushabomwe - Kazooba (2006), Lois and Annette (2005), found out that MSEs are not performing to the desired expectations and if this situation is not addressed, then the MSEs contribution to the economy is likely to be affected. Moreso these studies had unresolved contradictions applicable to MSEs thus, calling for a new study in a developing country setting like Kenya to be done and help in establishing the relationship between financial management practices and performance of MSEs. Therefore, this study is important not because it fills the gap, but also it sets out to address this gap knowledge.

Locally, studies on financial management practices that have been done include: Wanyungu, (2001) who did a research financial management practices of micro and small enterprises in Kenya, A case of Kibera, while Mundu (1997) did a research on selected financial management practices by small enterprises in Kenya. None of these local studies has ever focused on financial management practices in micro and small enterprises in the whole of Kenya. It is in this light that the current study seeks to fill the existing research gap by studying the Influence of Financial Management Practices on the Performance of Micro and Small Enterprises in Kenya.

Objectives of the Study

General Objective

The main objective of this study was to explore the influence of financial management practices on the performance of Micro and Small Enterprises in Kenya.

Specific Objectives

i. To assess the effect of financial innovations on performance of Micro and Small Enterprises in Kenya.

ii. To establish whether investment activities affects performance of Micro and Small Enterprises in Kenya.

iii. To determine the effect of risk management practices on performance of Micro and Small Enterprises in Kenya.

iv. To find out the effect of working capital management on performance of Micro and Small Enterprises in Kenya.

Literature Review

Schumpeterian Theory

Schumpeter, as cited by Swedberg (2000), pointed out economic behavior is somewhat automatic in nature and more likely to be standardized, while entrepreneurship consists of doing new things in a new manner, innovation being an essential value. As economics focused on the external influences over organizations, he believed that change could occur from the inside, and then go through a form of business cycle to really generate economic change. He set up a new production function where the entrepreneur is seen as making new combinations of already existing materials and forces, in terms of innovation; such as the introduction of a new good, introduction of a new method of production, opening of a new market, conquest of a new source of production input, and a new organization of an industry (Casson et al., 2002). For Schumpeter, the entrepreneur is motivated by the desire for power and independence, the will to succeed, and the satisfaction of getting things done (Swedberg, 2000). He conceptualized 'creative destruction' as a process of transformation that accompanies innovation where there is an incessant destruction of old ways of doing things substituted by creative new ways, which lead to constant innovation (Aghion & Howitt, 1992).

The entrepreneur's crucial significance to the dynamics of the capitalist system flows from the fact that it is the entrepreneur's innovations that disrupt the economy and move it forward. Rather than adapting to external pressures, the entrepreneur destroys the static equilibrium from within the system by inventing new products, processes or behaviors that contrast the routine systems and activities (Andersen, 2004; Drejer, 2004). The Schumpeterian Theory is important in guiding the entrepreneur in such a case. The above instigated the first research question.

McClleland's Need for achievement Theory

One of the early psychological studies of entrepreneurship is that of David McClelland (McClelland, 1961). His objective is to identify and to analyze the psychological factors which produce entrepreneurial personalities. David McClelland and his associates proposed the McClelland's theory of Needs also referred to as the Achievement Motivation Theory (McClelland 1961). This theory states that human behavior is affected by three needs - Need for power, achievement and affiliation. It proposes that individuals with high achievement needs are highly motivated by competing and challenging work. They look for promotional opportunities at work and have a strong urge for feedback on their achievements (Quince & Whittaker, 2003). McClelland described such individuals as gamblers as they set challenging targets for themselves following which they take deliberate risks to achieve those targets. Such individuals look for innovative ways of executing their jobs and perceive achievement of goals as a reward more valuable than financial reward.

Individuals with greater power and authority will perform better than those possessing less power (Aagaard & Hauer 2003). Generally, managers with high need for power turn out to be more efficient and successful as they are more determined and loyal to the organization they work for. The need for power can be viewed as the need to have a positive effect on the organization and to support the organization in achieving its goals. In the context of this study it will be investigated whether successors motivated by the need for power will steer the firm to great heights. The McClelland Theory will be used to investigate the second research question being: How does investing affect performance of Micro and Small Enterprises in Kenya?

Modern Portfolio Theory

Modern Portfolio Theory is Harry Markowitz's theory of portfolio choice in an uncertain future. In this theory, he quantified the difference between the risk of portfolio assets taken individually and the overall risk of the portfolio (Amenc & Le Sourd, 2003). The theory offers a solution to the problem of portfolio choice for a risk-averse investor: the optimal portfolios, from the rational investor's point of view, are defined as those that have the lowest risk for a given return. These portfolios are said to be mean-variance efficient (Reilly & Brown, 2003).

While it is desirable to maximize expected returns, it is equally important to keep the risk component under control, especially for investments that depend heavily on the volatility factor such as Options. For institutions that invest heavily in different types of financial instruments, such as banks or hedge funds, there is a strong need to integrate and measure the risks involved firm-wide. This gives rise to the development of Value-at-Risk, which summarizes the worst loss over a target horizon with a given level of confidence (Jorion, 2001).

The Signaling Model

Leland and Pyles (1977) signaling model gives a different view. Their model looked into the ownership of a company. According to them, an entrepreneur's fractional ownership of a company provides a credible signal to rational investors of a company's true value. Entrepreneurs will only accept higher risks if they are certain of the company's prospects. This action serves as a signal to investors of the superior quality of the company's value. Research using signaling theory in the context of entrepreneurial venture has shown the promise and its relevance (Gulati & Higgins, 2003) and acquisition market (Reuer, Tong, & Wu, 2012).

According to Hill et al (2010), Nazir and Afza (2009) the optimal level of working capital is the one that ensures a balance between risk and efficiency. According to Deloof (2003), efficient WCM ensures an optimal level of working capital is maintained in order to maximize shareholder value and wealth. The objectives of maximizing profit or shareholder value are some of the key objectives for a company, however certain levels of liquidity is essential to ensure short term maturing obligations are met when they arise. Efficient utilization of the firm's resources, as it relates to WCM, means that managers should seek effective and efficient ways to deal with the cash available for the day-to-day operations in order to achieve the optimum impact. Good WCM leads to increased cash flows, and thus leads to lesser need on external financing; therefore, the probability of default for the firm is reduced. A key factor in the working capital management is the cash conversion cycle (Deloof, 2003).

Financial innovations

Innovation is the process of creating a commercial product from an invention (Wolf & Schoorlemmer, 2007). Innovation can deliver four types of benefits besides cash: knowledge, brand, ecosystem and culture. But the most important reason for innovation in an organization is to make profit. A firm makes profit by offering products or services at a lower cost than its competitors or by offering differentiated products at premium prices that more than compensate for the extra cost of differentiation (Afuah, 2003).

Lehtimaki (2001) attributed the emergence of new ideas for product innovations in MSEs to entrepreneur. MSEs very actively explored new product ideas and the most frequent way of achieving this included contacts with customers. Chanaron (2008) identified demand placed on business by customers/clients, close working relationships with a key customer and close analysis of competitor products are the major drivers of innovation in MSEs covered in three different countries: UK, France, and Portugal.

Investing activities

Investing can be described as the redirection of resources from being consumed today to creating benefits in the future (Sullivan & Sheffrin, 2003). In other words, it is the use of assets to earn income or profit. Although it is no longer a bartering society where goods were often more perishable, it is preferable, if not essential, to invest instead of keeping assets idle, so that investments can grow to fight against inflation and future uncertainties. MSEs must be able to respond quickly and efficiently to international market signals to take advantage of investment opportunities and reap the benefits of the international trading system. This means they need to be competitive and productive. Effective business support systems are needed to enhance competitiveness and productivity of MSEs. Development of an effective business support system is also a key condition for the success of investment capacity building. It requires business support agencies (including financial institutions), which are customer-oriented and which have a demonstrated capability of penetrating the MSE sector.

Multinational enterprises seeking out new markets and investments offer capable MSEs the opportunity to insert themselves into global value chains through subcontracting linkages, while those that are unable to do so increasingly face the danger of losing their existing markets. Competition within the developing world for export markets, foreign investment and resources is also intensifying. Against this backdrop of increased global competition, MSEs associations, support institutions and governments in transition and developing countries have to adjust and adopt new approaches and invent new ways of working together to foster MSEs competitiveness

Risk management

Risk management is defined by Dickson (2009) in Valsamakis et al (2002) as “the identification, analysis and economic control of those risks which threaten the assets or earning capacity of an organization.” As such the management of risk has, explicitly or implicitly, become part of a strategic component of the modern organization’s survival and development (Waring & Glendon, 2008). Risk can be seen as the possibility of economic or financial losses or gains, as a consequence of the uncertainty associated with pursuing a course of action (Chapman & Cooper, 1983). Risk pervades all human actions (to varying degrees), all kinds of business and every area of management of a company. However, in many cases, risk can be predicted on the basis of experience, trying to better govern the disorder. Risk management (RM) has the task of identifying risks, measuring the probability and the possible impact of events, and treating risks, eliminating or reducing their effect with the minimum investment of resources. RM is being developed and adopted in a lot of fields within enterprise management.

Micro, small and medium sized enterprises are considered significantly important to the growth of any economy. However, these businesses are vulnerable to risks, such as business risk, finding, budgeting, etc. The scheme to prevent risks of small businesses, nevertheless, is not systematically developed and performed. MSEs require the adoption of a risk management strategy and methodology, because they lack the resources to respond promptly to internal and external threats, leading to potentially huge losses that seriously threaten their survival.

Studies by the Singapore Government (2012) and the Institute of Chartered Accountants in England and Wales coincidentally prove that the most significant risk among small businesses involves human factor. High degree of employee turnover and shortage of know-how experts both result in wastage of manpower and additional cost of training. In long term, human factor will lower the productivity and affect the brand image of small businesses as an employer (Alpa, et al. 2005).

Working capital management

The study done by Garcia-Teruel et al, (2007) entitled "effects of working capital management on MSE profitability in Spain" found a significant negative association between working capital management and MSE profitability. In variance to the findings of Garcia-Terel (2007), the results from the study conducted by Uyar (2009) indicate significant positive correlations between working capital components with firms' performance in Malaysia. Garcia-Teruel and Martinez-Solano (2007) investigated the effects of working capital management on the profitability of a sample of small and medium-sized Spanish firms. Their findings revealed that managers can create value by reducing their inventories and the number of days for which their accounts are outstanding. Moreover, shortening the cash conversion cycle may improve the business profitability.

Performance of MSEs

Performance is one of the most important objectives of financial management because one goal of financial management is to maximize the owner's wealth (McMahon, 2005). Thus, performance is very important in determining the success or failure of a business. At the establishment stage, a business may not be profitable because of investment and expenses for establishing the business. When the business becomes mature, profits have to be produced. Due to the importance of performance, Edmister (2007) among other researchers have suggested that small firms need to concentrate on performance. Jen (2003) found performance to be a significant determinant of a small firm's credit risk. Thomas and Evanson (2007) stress the aim of a business is not only the generation of sales, but also generation of profits. Profit is especially important because it is necessary for the survival of a business. Low performance contributes to under-capitalization problems because it leads to retained earnings and therefore to a reliance on external capital (Davidson & Dutia, 2001).

Data Analysis/Findings

Regression analysis

This section presents a discussion of the results of inferential statistics. The researcher conducted a multiple regression analysis so as to determine the relative importance of each of the variables with respect to the influence of financial management practices on the performance of Micro and Small Enterprises. The researcher used the statistical package SPSS and advance excel, to enter and compute the measurements of the multiple regressions for the study. Findings are presented in the following tables;

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	. 838[a]	.828	.810	.625

Source: Research, 2014

a. Predictors: (Constant), financial innovations, investment activities, risk management practices, and working capital management.

b. Dependent Variable: financial management practices

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (financial management practices on the performance of Micro and Small Enterprises) that is explained by all the 4 independent variables (financial innovations, investment activities, risk management practices, and working capital management).

The four independent variables that were studied, explain 82.8% of variance in financial management practices on the performance of Micro and Small Enterprises in Kenya as represented by the R^2. This therefore means that other factors not studied in this research contribute 17.2% of variance in the dependent variable. Therefore, further research should be conducted to establish the influence of financial management practices on the performance of Micro and Small Enterprises.

ANOVA (Analysis of Variance)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	40.566	3	.384	83.0	.001[a]
	Residual	4.686	7	.396		
	Total	43.353	11			

Source: Research, 2014

a.Predictors: (Constant), financial innovations, investment activities, risk management practices, and working capital management.

b. Dependent Variable: financial management practices

The F critical at 5% level of significance was 5.33. Since F calculated is greater than the F critical (value = 83.0), this shows that the overall model was significant. The significance is less than 0.05, thus indicating that the predictor variables), explain the variation in the dependent variable which is financial management practices on the performance of Micro and Small Enterprises. If the significance value of F was larger than 0.05 then the independent variables would not explain the variation in the dependent variable.

Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	4.421	0.89		7.648	0.005
	Financial innovations	3.199	0.361	0.381	0.375	0.004
	Investment activities	3.175	0.348	0.67	0.355	0.045
	Risk management practices	2.554	0.651	0.426	0.276	0.003
	working capital management	2.363	0.647	0.432	0.234	0.001

Source: Research, 2014

a. Predictors: (Constant), financial innovations, investment activities, risk management practices, and working capital management.

b. Dependent Variable: Financial management practices

From the regression findings, the substitution of the equation (**Y = β0+ β1X1 + β2X2 + β3X3 + β4X4)** becomes:

$Y = 4.421 + 3.199\,X_1 + 3.175X2 + 2.554X_3 + 2.363\,X_4$

Where Y is the dependent variable (influence of financial management practices on the performance of Micro and Small Enterprises) X_1 is financial innovations, X_2 is investment activities, X_3 is risk management practices and X_4 is the working capital management.

According to the equation, taking all factors (financial innovations, investment activities, risk management practices, and working capital management.) constant at zero, influence of financial management practices on the performance of Micro and Small Enterprises will be 4.421. The data findings also show that a unit increase in financial innovations, variable will lead to a 3.199 increase in financial management practices on the performance of Micro and Small Enterprises; a unit increase in investment activities will lead to a 3.175 increase in financial management practices on the performance of Micro and Small Enterprises; a unit increase in risk management practices will lead to a 2.554 increase in financial management practices on the performance of Micro and Small Enterprises; and a unit increase in working capital management will lead to a 2.363 increase in financial management practices on the performance of Micro and Small Enterprises . This means that the most significant factor is financial innovations.

Performance of MSEs

According to the analysis of findings, the respondents strongly agreed with the statement that Performance is very important in determining the success or failure of a business in this case Micro and Small Enterprises in Kenya . Secondly respondents agreed with the statement that the aim of a business is not only the generation of sales, but also generation of profits which influences performance of Micro and Small Enterprises in Kenya; Thirdly respondents agreed with the statement that Profit is especially important because it is necessary for the survival of a business therefore influencing performance of Micro and Small Enterprises in Kenya finally respondents indicated that Low performance contributes to under-capitalization problems because it leads to retained earnings and therefore to a reliance on external capital which influences performance of Micro and Small Enterprises in Kenya.

The study findings relates with literature review by Uyar (2009) who indicated that the aim of a business is not only the generation of sales, but also generation of profits; that Profit is especially important because it is necessary for the survival of a business and Low performance contributes to under-capitalization problems because it leads to retained earnings and therefore to a reliance on external capital.

Conclusions

This study concludes that financial innovations influence the performance of Micro and Small Enterprises in Kenya to a very great extent and that the reason for innovation in an organization is to make profit. Financial innovation is essential in order to generate long term stability and that Innovation requires the firm to have competences relating to technology. Further study concludes that customer perspective of newness necessitates a change in consumer behavior to accommodate new product usage conditions.

This study concludes that Investing can be described as the redirection of resources from being consumed today to creating benefits in the future; that It is essential to invest so that investments can grow to fight against inflation and future uncertainties and that Development of an effective business support system is also a key condition for the success of investment capacity building while as investing requires business support agencies which have a demonstrated capability of penetrating the MSE sector.

Further the study concludes that Risk has become part of a strategic component of the modern organization's survival and development; that risk can be seen as the possibility of economic or financial losses or gains; that MSEs require the adoption of a risk management strategy and methodology; and that the most significant risk among small businesses involves human factor.

Finally the study concludes that there's a statistical significant between working capital and firm performance; that There exists a highly significant negative relationship between the time it takes for firms to collect cash from their customers; that heavy investment in inventory ties up capital which in the end reduces firm' profitability; and that there is need for a tradeoff between receivables and holding inventory if the firm is to attain the required profits.

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