

**THE RELATIONSHIP BETWEEN FINANCIAL MANAGEMENT  
PRACTICES AND FINANCIAL PERFORMANCE OF SMES IN  
NAIROBI CENTRAL BUSINESS DISTRICT KENYA**

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## **DECLARATION**

This research project report is my original work and has not been submitted to any other University for examination purpose.

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## **DEDICATION**

This research project is dedicated to parents and my siblings for their sacrifice and motivation towards pursuing and completion of this course. Without them it would not be possible.

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## **ABSTRACT**

The objective of the study is to establish the relationship between financial management practices and financial performance of small and medium enterprises in Nairobi central business district. The financial management practices are said to be the functions conducted by the accountants, chief financial officer and directors in the department of budgeting, procurement, asset management and control. The researcher does not know any study that has been done to determine the degree to which the SMEs have embraced financial management practices and how these practices have impacted on their performance. The research design used in the study was a cross-sectional research design and the secondary information and data was used to collect the data. The target population of this study was 398 SMEs operating in the Nairobi CBD the sample was 100. Data collected was collected using secondary data and analysis statistically using the regression and ANOVA. The analysis tool that was used is the SPSS. This statistic is significant level of 0.000 confidence level with  $p = 0.000$ . The researcher studied financial performance of SMEs for five years starting from 2012 to 2015 financial years to establish the relationship between financial management practices and financial performance. The study used four aspects of financial management practices which were ratios that were derived from the financial statement namely; current ratio, asset turnover, debt to equity ratio size which is the natural log of sales.

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## **LIST OF ABBREVIATION**

<b>ARR</b>	Accounting Rate of Return
<b>CBD</b>	Central Business District
<b>GDP</b>	Gross Domestic Product
<b>ROA</b>	Return on Asset
<b>ROE</b>	Return on Equity
<b>ROI</b>	Return on Investment
<b>SME</b>	Small and Medium Enterprises
<b>WCM</b>	Working Capital Management

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# CHAPTER ONE

## INTRODUCTION

### 1.1 Background

Small and medium enterprises have contributed to development of economy of the third world countries. Most of the SMEs that operate are local organizations which are also small in size, a percentage of these always do have prospective to progress and become large companies on condition that the initiators and the business oriented persons of those firms (Nichter & Goldmark, 2009). Although there is evidence in regard to the positive association in a midst of financial management techniques by SME entrepreneurs and the performance, the vital responsibilities among the two are not so far made clear. The aim of this study is to identify some relationship between the financial management practices and SME performance.

Financial Management determines the organizational decisions that institutions make they are tools used to analysis and make the decisions. 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 (Pandey, 2010). Financial management practices applied the models of money, time and risk and the way they are relates to each other (Gitman, 2011). Financial management is 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

businesses(Meredith, 1986) with the main objective of ensure the financial intentions are met.

Contemporary approach of financial management emphasizes on the utilization of the funds effectively. According to this methodology financial management can be subdivided into three distinct choices which include financing, investment, and dividend choices (Brealey & Myers, 2007). Investing in fixed assets as capital budgeting along with investing on current assets in place of working capital management is the investment decision. Financing decisions aims at increasing income from various resources depending on resolutionmade by the management on nature of source, length charges of financing and the returns that would be yield. Dividend decisions involve conclusions on the sharing of profits to the shareholders and to be retained (Brealey & Myers, 2007).Sound statement of financial position and improved profit of the organization is elaborated when the practices of financial management are comprehensive.

### **1.1.1Financial Management Practices**

In regard to Moore and Reichert (1989), financial management techniques were purported to be the techniques executed by the accountants andor other directors' specialists in the department of budgeting or any other related department. The techniques can also be done by an entrepreneur while also gaining the knowledge from the specialist. These financial management techniques like use of accounting information system and asset management and ability to pay their obligations as they fall due can be done by the SME owner while the rest can be done by the specialists.

Accounting Information System points out an assimilated structure within an enterprise that engages tangible resources to convert economic facts into financial information to the range of users in need. The organization to administer its knowledge effectively through the use of technological antics that collaboration of human understanding and technology. (Bhatt, 2001; Thomas & Kleiner, 1995). Firm's current assets are considered to be working management which is defined differently. Working capital is said to be company's total investment from current assets, they are the assets that a firm converts them into cash within a period of less than a year (Keown; Martin; Petty; & Scott, 2005). Investment in working capital comprises of shortage and carrying costs which are the current liabilities which aids the firms to discover the balance between the two. Capital structure is known as the relative of debt-to-equity ratio determined to invest in an organization. It is the pertinent summation of perpetual short-range and long-range obligations, preference shares and common shares applied in order to finance a corporation. Stated differently financial structure is a sum of total current obligations, long term obligations, preference shares and common equity used to finance the organization. Thus according to (Boateng, A 2004) capital structure is a subset of financial structure, these are consequently originators of enterprise financing which are permanent.

Accounting information provided by the financial statements are analyzed by the use of accounting information systems. Romney (2009) argued computer-centered accounting information systems automatically streamlines the final information which is one of the advantage of the system. As for Financial Reporting Analysis (FRA), the traditional activities in accounting does not realize the goal of the enterprise until it is analyzed for the purpose of managerial decisions (Gitman, 2011). WCM are decisions by management in regard to working capital and short term financing (Garrison, 1999).

The link amongst a current assets and current liabilities are taken care by this practice. Non-current assets management defined to be a departmental function that tries to have the record of fixed assets in order to practice the financial accounting, deterioration maintenance and insurance against theft (Garrison, 1999). (Romney, 2009). Capital structure of an organization can be defined as the determination and arrangement of different wellsprings of financing which are either the equity financing or the debt financing.

### **1.1.2 Financial Performance**

McMahon (1995) defines the financial performance as an independent determinant of how well a company uses its assets for its principal reason of business which is to create and increase income. In the bigger picture, financial performance indicates the extent to which financial objectives has been achieved. It is the gradual activities by the firm to establish the outcomes of the organization's strategies and also the firms operations in terms of money. The performance were used as the overall determinants of a business's economic health for a predetermined period, and can also be used to match the similarity between companies in the same industry or to do a comparison test of industries or sectors in aggregate (Padachi, 2006).

Enterprises can determine the financial performance by using of accounting information and the values from the security market in a setting of financial management methods. Managers determines the level of performance attained by using the company stock market values. Investor maybe concerned with examining the modification in the value of the market. Firm achievement is examined over time by adjusting the average stock market annually. The value is regularly acquired through computing the changes of share price per annum. Management effectiveness is

dictated by high performance and efficiency in making use of enterprises resources which therefore contributing to the nation's economy(Naser and Mokhtar, 2004).The financial performance of organizations are generallydeterminedby means of a mixture of financial ratios scrutiny, benchmarking, measuring performance compared to budget or a mixture of these methods.

According to Resseeuw(1997) the study has shown availablelink between the size and the performance. Yoon (2004) concluded that performance of a company can diminish if the size of the business growspast the most favorable level. If the managers and owners of the businesses find it hard to control the managerial actions due to the size then theperformance will be a negative (Pi and Timme 1993; Goddard et al. 2005). Small and medium enterprises have a less rigid organizational structure, therefore easy to realize growth opportunities. SMEs may be in a better position to adjust to the continuous innovation together with networking with others. The size the business maybe measured by the total asset, the total sales and the number of employees

Liquidity determines the ability the firm hasto pay its debt as they falldue, without interfering with the dailybusinesses organization has. It is calculated from the statement of financial position where itevaluates of the relations in between assets and company's obligations and operational liquidity known as the cash flow measures. Solvency brings in light to the indication of the business that is able tosurvive in adverse situations by relaying information about the operation capability to carry on with itsdaily operations after a period of financial difficulty (Harrington & Wilson, 1989). It is the capital of borrowed by the entrepreneur in relation to the amount that the owner hascapital invested for the business

Profitability measures the magnitude of which a firm is able to generate its earnings. The analysis concentrates on how revenue is related to expenses and the level on which profits are in relation to the magnitude of investment in the firm. Profitability of a particular institution is determined by the ROA, ROE, operating and net profit (Hansen & Mowen, 2005). Return on assets is an impression of how the enterprise is making profit in with the use of its total assets. It shows how the enterprise efficiently and effectively manages and utilizes their assets to generate income. This is computed by dividing a business's profits gained annually by the total assets and it is shown as a percent.

### **1.1.3 Relationship between Financial Management Practices on Performance**

The eventual aim of financial management is to increase the wealth of the company's shareholders. Financial management techniques are critical to the accomplishments of the organization for financial planning, controlling of working capital, control and analysis, accounting information, management accounting and capital budgeting. Accounting systems are the sources of data that proprietors and managers of company's require while operations carry on in any industry for they are used to measure the financial performance. It is for that reason vital that the accounting practices of organizations convey full and important financial information required to enhance progress financial decisions made by entrepreneurs. Profitability management is involved with maintaining and ensuring the earnings are sufficient and surplus through control to cost, putting attention to pricing policy, volume of sales, inventory management and capital expenditures. Liquidity management ensures that the business obligations are met when they fall due. McMahon (1995) also observed growth as an additional concern of financial management in relation to liquidity, growth and

profitability. Financial management has an objective of ensuring maximum share price of securities in the market also ensuring future value of the firm.

### **1.1.4 Small and Medium Enterprises in Kenya**

Governments and Non-government institutions have recognized the significant of the SMEs they are playing for the development of the nation. Consequently, most legal policies are created in favor of backing up SME sector progression by introducing various plans that varies from tax incentives to technological support, from regulatory requirements to rule intervention, education and other forms of commerce development services (Kagiri, 1995). SMEs throughout the sectors industries in the Kenyan economy and offers some of the most productive sources of recruitment and are the backbone of large industries which are vital to the current economy. Currently small and medium enterprises are found across the country and holds a huge prospective to generate many of the employments, and to improve the country's economic benefits. The Kenya Government Baseline Survey (1999) defines small and medium enterprises as cooperation of skilled and unskilled segments recruiting 10 to 100 employees' with 11-50 employees for a Small-scale enterprises.

The GDP contribution by the SMEs is higher than other and creating more jobs for both skilled and unskilled personnel (Republic of Kenya, 2006). Approximations of 2005 indicated that, the SME sector had hired roughly 5 million persons which has been gradually increasing (Migiro, & Wallis 2006). It is recognized that SMEs plays a fundamental task in the Kenyan private sector. The SME took part in the general investment, be it manufacture of goods, provision of services, they have also been involved in risky investment chances and in increasing businesses in the market. In Kenyan SMEs have contributed much in the engagement of pricing signals in the

different segment such as garbage collection, delivering urban service; urban transport, water supply and manufacturing various products both for home and money-making applications (ILO, 1972). The importance of small and medium businesses activity in Kenya have grown continuously as from the inception of year 1972. In Kenya, it is currently extensively renowned that the advancement of the SME sector is a feasible and vibrant plan of accomplishing national objectives, as well as generation of employment and the stable growth amongst sectors and sub-sectors. The conclusion year 2003 SME Baseline Survey highlighted that the imperative role of national's development progression that SMEs has participated in, predominantly in the perspective of creating jobs to the society and improving income opportunities for most of deprived people all over the nation. To be sure, the SME sector offers significantly high employment the formal sector than does (Central Bureau of Statistics, 2002).

## **1.2 Research Problem**

Financial management techniques are decisive to the continued existence and efficiency of most business enterprises of all natures. Research to find the reasons of business failure shows that financial management contributes to it if poorly or carelessly done may be cause of failure major (Berryman & Peacock, 1991). Financial management techniques approved by corporations are assumed to increase the shareholders wealth when they have contributed positively toward the business performance. Under the hypothesis of economic reasonable, comprehensive financial management practices can be looked upon as a method through which a business applies in the view of accomplishing its purposes. SMEs in Kenya have played a significant role of improving the GDP in the economy. SMEs in the manufacturing sector are said to be enterprises with permanent workers not beyond 100 and or sales turnover don't exceeding Ksh 150 million per annum.

Small and medium enterprises have been imperative to the development process and that it would have factors that benefit African countries to alleviate SMEs for further growth. The small and medium enterprises have a paramount function to participate in economic development, lessening poverty and creation of employment in third world countries (Hallberg, 2000). Through proper management and capitalizing on the investment the small and medium enterprises have the ability to grow and able to bridge the gap in the society. Studies on how the financial management practices relates to financial performance have brought about mixed results.

The association among capital budgeting practices and the financial performance in US shows no constant association irrespective of methods the growing adoption of capital budgeting Klammer (1973). In their studies of company performance and application of contemporary analytical methods and financial methods studying 500 firms in US (Moore J and Reichert A 1989) discovered that organizations using the refined capital budgeting techniques are ensured of enhanced financial performance than average. More precisely, companies using recent inventory controlling procedures and Internal Rate of Return (IRR) conveyed greater financial performance, unlike those corporations applying approaches such as Payback technique and Accounting Rate of Return (ARR), (Raheman and Nasr, 2007).

Most of the researches that has been has associated other factors to financial performance in different industries for example (Kitonga, 2013) conducted a research to establish the link amongst financial management techniques and the financial performance in the Kenya shipping industries. Other studies are from different context Wanyugu (2001) did a research of financial management practices of SMEs in Kibera, Kenya. The SMEs in Nairobi and in Kenya has practices that aim at ensuring that it

survives in the industries. Atieno M J (2013) conducted a research on the relationship between financial planning and the financial performance of the SMEs in Kenya. There is no study that has been conducted to relate the performances with the financial management practices. Therefore this research aims at bringing more light how the financial management techniques relates to the performance of SMEs. The research aims at addressing the question: What are the relationship between the financial management practices and the financial performance of the SMEs?

### **1.3 Objective of the Study**

This objective study was to determine the relationship between financial management practices and financial performance of SME in Nairobi CBD.

### **1.4 Value of the Study**

This study provides some understanding for finance personnel on the financial management practices and how they are related with organizational performance. It would as well provide crucial information to business firms mostly in to the entrepreneurs on the manner in which it will take full advantage of the usage of financial policies and performance. By considering the most fundamental financial practices that may be applied, the enterprises are able strategize themselves to ensure success.

This study also acts as a reference point to other researchers as it relates the existing attention in justifiable financial management practices in different industries.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter aimed at looking at the theoretical review, financial performance measures and empirical review.

#### **2.2 Theoretical Review**

##### **2.2.1 Proprietary Theory**

According to this theory, a business owned by a person or group of people with a center of interest and is called the proprietor. Accounting serves the proprietors' interests and the in the financial statements contents are stated to be understood by stockholder. The notion of proprietorship initially originates from the logic of the exposition of double-entry bookkeeping: the equation for it can be interpreted that assets are for the proprietor and the liabilities are their obligations. Thus, revenues received by the SMEs increases of the proprietor's wealth while the liabilities decreases of the proprietors' wealth Hendriksen & Breda (2001). It is therefore important to make sure that capital assets are used efficient in order to increase the profit. Interest, taxes, and other deductions are expenses since they decrease the proprietorships and the net income is dividend which is paid to the stockholders.

Husband (1954) favors the proprietary theory due to the fact that it provides logic and consistency in accounting putting into account that stockholders bear the ultimate risk. Proprietary theory best for sole proprietorship like SMEs but complex when the businesses are bigger. However, accounting practices are still affected by this theory implying that retained earnings are the net wealth of the stockholders and the business

owners. The owners of the SMEs will use the retained earnings to expand its businesses and also to invest. The comprehensive income, which includes all items affecting the net wealth, is one of the accounting practices that reflect the influence of the proprietary theory (Hendriksen & Breda, 2001)

### **2.2.2 Residual Equity Theory**

The deviations in asset valuation, profits and in residual income and concern of other shareholders are the retained earnings of the common shareholders. The particular equities are the obligations to the creditors and the others of preference shareholders whereby in the statement of financial position formula is denoted as assets less particular equities are equivalent to retained earnings. The equity of the shareholders in the statement of financial position ought to be open separately from the equities of ideal shareholders and additional particular equity holders. According to Hendriksen (1982), the residual earnings is viewed as a perception where between the proprietary theories in addition to the entity theory

The aim of the residual equity draws near to convey useful information toward general stockholders in support of investment resolutions. In a going concern condition, the recent value of common share mainly relies on the expectation of upcoming dividend payables. Expected dividends are reliant on the expectations of total income with a reduction of precise contractual debts, payment to precise share holders, and investing back to the firm. Subsequently financial statement do not commonly prepared on the origin of a guaranteed liquidation, the information supplied concerning the retained equity should be functional forecasting probable expected dividends to common shareholders together with liquidation dividends (Hendricksen, 1982). Revenues are increase in the entrepreneurship and operating cost are reductions. Therefore net profit

accrues straight to the entrepreneur, to be precise; it represents a boost in the possessions of the proprietor. The entrepreneurship is measured by the net value of the trade to the proprietor which is the richest idea (Hendricksen, 1982).

### **2.2.3 The Pecking-Order Theory**

The management in this theory would prefer to finance first from retained equity, then the debt, followed by other forms of finance like convertible loans, and last of all by using externally issued equity. The insolvency, agency cost, and information asymmetry play subsequently small role in the effect of the capital structure policy. Managers of the SMEs mostly prefer investing where there is likely to increase the earnings. They make their decision on the financial structure from the most priority to least priority the pecking order theory (Norton 1991). Holmes et al. (1991) this theory is mostly used by small business because the owner do not want to reduce their ownership and share it with others. SMEs have restricted in accessing capital and money markets and consequently experience much from undercapitalization which is therefore likely to have expensive funds which act as a brake on their economic. Large companies use higher levels of debt financing compared to small businesses. According to the pecking order theory, the small businesses finds some limitations when it comes to equity funding McMahon et al. (1995). Small enterprises normally do not have the alternatives of issuing additional shares to the public and also the entrepreneurs always oppose the dilution of their ownership.

### **2.3 Financial Performance Practices**

Financial performance intends to assist the owners and managers of businesses examine their operations from a financial point and provision of important information required for good managerial decisions. It is impossible to manage or foresee all the

factors that affect the final outcome of any company's decision. It is also impossible to have obtain all of the information that would be required to make decision. Through the effective financial management analysis the decision making can be enhanced through using accessible information. Crane, (2010) approve the following measures for financial analysis which was stated in five broad groups: liquidity, solvency, profitability, repayment capacity and financial efficiency.

### **2.3.1 Liquidity**

Liquidity determines the capability the business has to meet obligations without interrupting the normal business operations. It can be measured by financial position which gives the link between assets and liabilities. Liquidity problem occurs when the debt payable becomes due before the firm has not converted assets to equivalent cash to settle. The suggested methods of determining liquidity are the current ratio and the working capital (Crane 2010). The current ratio determines the relative affiliation between the current asset and liabilities. Working capital consequently measures of total cash accessible to buy inventory after selling all current assets and paying all current liabilities. Working capital is conveyed in absolute monetary units; hence, it determines the size of the business.

### **2.3.2 Solvency**

Solvency is use to determine the borrowed capital by the company in relation to the owner's equity used to invest in the business. It provides the capability of the firm to pay back all debts if all the assets were sold and also tells whether the business has the capacity to endure risks by providing information about the ongoing concern of the operations. Solvency determines what would happen in the event of all assets were sold and that cash used to pay all the liabilities. The appropriateness of equity depends on

the size of business, making assessments hard without using ratios for SMEs. According to Crane 2010 the financial ratios mostly used to determine the solvency are the debt-to-asset ratio, the equity-to-asset ratio and the leverage ratio also known as debt to equity ratio. The debt to asset ratio is used to express total business liabilities as a proportion of total business assets. The equity-to-asset ratio expresses the percentage of total assets financed using owner's equity. The SMEs mostly uses the debt to equity to reflect the total amount contributed by the owner as the equity of the business and the extent to the business has debt capital.

### **2.3.3 Profitability**

Profitability measures the degree to which a business uses the factors of production to generate profit. It is determined by the sales and expenses and the level of profits is related to the size of investment in the business. Most common measures are return on assets (ROA) and of return on equity (ROE), operating profit margin and net income. ROI is the cost of investment is deducted from the gains from the investment and the difference is divided by the investment cost. The gain obtained by the investment is the profits attained from sale of the investment or interest gained. ROI is actually a widespread determinant for the reason that its adaptability and it is easy to use. If an investment gains a negative return on investment, or else if there exists an alternative opportunities with a higher ROI, then the investment ought not to be undertaken.

It evaluates the profit of an organization in relation to its total assets. ROA provides some impressions for the management as to how effective the assets are exploited to create earnings. It is computed by dividing the profits with the total assets and expressed as a percent. ROA aids at determining the earnings that have been generated by investing in the capital assets. ROA for public corporations can differ considerably and

will extremely be depending on the industry. The ROA measures the efficiency of all assets to generate profit and is mostly used as an overall index of profitability, the higher the value, the more business is profitable. The ROE measures the rate at which the owner's equity employed is bringing profit in the business.

### **2.3.4 Repayment Capacity**

Repayment capacity is firms' ability to pay debts from both business income and non-business income. Unprofitable business survives in the long-term due to inclusions of income from non-business sources to compensation business losses. They are commonly determined by the debt term, term debt repayment margin, capital lease coverage ratio and capital replacement. The term debt and capital lease coverage ratio is used to determine the capacity a borrower has to pay all required term debt and capital lease payments. With a ratio over 1:1, then the borrower has greater the margin to cover the payments.

### **2.3.5 Financial Efficiency**

Financial efficiency determines the level that the business uses its assets to create revenue and efficiency of production process. The financial efficiency is determined using asset turnover ratio, operating expense ratio, depreciation ratio, interest ratio and net income ratio. SMEs mostly use the asset turnover ratio to determine how efficiently the assets generate revenue. If the ratio is high then the assets efficiently the used to generate income. The net income ratio show the percentage of the total revenue that the SME will remain with after all the expenses has been deducted.

## 2.4 Empirical Review

Klammer (1973) in his study concluded that, despite the increasingly use of the capital budgeting techniques the link available in the financial performance and capital budgeting techniques was irregular. In their multivariate study Moore and Reichert (1989) found out that organizations that implement these sophisticated capital budgeting methods are assumed to perform superior compared to average firm financial performance. These therefore was an indication that the use of financial management effectively would automatically lead to skyrocketing performance and therefore the firm would be able to maximize the shareholders wealth.

According to Kazooba (2006), Uganda is fast in starting SMEs in Africa. It is also in the highest in the number of SMEs that performs poorly SMEs and high closure of SMEs. However, the study conducted didn't indicate the relationship between financial management and business efficiency of SMEs. Most enterprises fail due to incapability of owners to organize and manage appropriately the current assets and current liabilities (Mbaguta, 2002).

D'Amboise and Gasse (1980) researched on the use of financial statement analysis by small manufacturers in Quebec, Canada, they discovered that small manufacturers in shoe and plastic industries and made some conclusions from the financial statements and the findings that manufacturing company's managerial decisions are based on the prepared financial reports. The research conducted by DeThomas and Fredenberger (1985) observed that 81% of the small businesses often obtained summary of financial information most of it being from the traditional statements and the bank reconciliations. The study further discovered that 61 percent of respondents felt the financial statements presented the information that is necessary for planning and

decision-making and 11% of respondents used the financial statement information for planning and evaluation. 2 percent of businesses exploited the financial ratio analysis, and few tried to have simple historical comparisons.

According to Blocks (1997) survey of 232 small businesses in the USA pointed out that payback technique is the most common model of investment selection for the small businesses, while large organizations extensively integrates discounted cash flow techniques in financial analysis of capital investment proposals (Proctor and Canada, 1992). This does not indicate any complexity simply because it is an expression of financial pressures being on the SMEs owner by banks. Payback period evaluated capital project by 51 percent of respondents, while 30% stated use of some deviation of accounting rate of return. Only 10 percent described use of discount cash flow methods such as 5% for net present value and 2% internal rate of return. This finding is steady according to Soldofsky (1964), the trend of using easy and sophisticated techniques for evaluating the project for the investment.

Small and medium businesses take on particular application, in the circumstance of the European Union in general and in the case of Portugal in specifically. Portuguese SMEs represents 99.8% of businesses according to National Institute of Statistics 2004, this leads to job formation and growth of the Portuguese economy. Taking into account the compatibility of SMEs in the context of the Portuguese economy, the likely positive manipulation of size to performance can contribute towards continued company's growth, which would be of advantage to the country's economy. In this context, Russeeuw (1997), researched on small firms and identified a positive relationship between size and performance. However, he concluded that the positive effect of size

on performance this continues until when the size increases the performance would start to decrease.

In Kenya, Mundu (1997) pursued to that small enterprises in Kenya evaluate assorted financial management techniques and approved that 66 percent of the respondents did not practice monetary budgeting, 70 percent of the business proprietors retained excess cash in the business and over 56% of the business owners viewed cash as the security to their wealth. Credit sales were made to the regular clients by about 70% of the respondents. More than 80% prepares a business strategy with the most common purpose of accessing finances. These conclude that the existence of SMEs comprehensively depends on the good exercise of prescribed and informal financial management.

## **2.5 Summary of Literature Review**

The situation has continually been discussed that financial management is used and is connected to the financial performance. Studies indicate some existence of complicated capital budgeting procedure like net present value and interest rate of return shows some affirmative affiliation within return on asset whereas the conventional technique exhibited an inconsequential association. Nevertheless, undesirable affiliation of capital budgeting methods with the financial performance has been reported by some studies. This designate that implementation of a variety of investigative tools are don't adequately take along with them high performance and that existence of factors for instance promotion, product advancement, staffing and training that have a superior influence on profitability.

Local studies mainly makes the use of the capital budgeting method in the large corporations and similarly in the banking industry. Their conclusions showed that

discounted cash flow processes was not comprehensively put in place to assess investment decisions. The report in the banking industry predominantly established the irresistible use of the traditional techniques of capital budgeting. Thus assumed these contradictory conclusions search sought to explore the affiliation of the financial management techniques on financial performance of the small and medium enterprises in Nairobi CBD.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter covered the design of the study, the target population, sampling and data collection method, measurement of variables and data analysis techniques.

#### **3.2 Research Design**

Research design is a plan that is generated with an objective to get answers to the study problem. Kothari (2003) said an understanding of circumstances for the collection and scrutiny of data in an approach that aims at combining importance research purpose. This study made use of the descriptive research design due to the fact that that SMEs ventures in different businesses. Cross-sectional survey research is vivid in nature and as defined by Glass & Hopkins (1984), vivid study design involves gathering data, organizing and tabulating to give the information. The study sought to find the relationship between financial management practices and performance of SMEs in Nairobi CBD.

#### **3.3 Population**

The population of the study consisted of the SMEs Nairobi Central Business District. There are 398 SMEs according to listed in the Kenya Business of period ended June 2017.

#### **3.4 Sampling**

A sample is stratified sampling method. The stratification is based on the split of the total population. The method intended at coming at section that would be the representation of the whole population. Mugenda and Mugenda (2003) argued saying

that at least 30 respondents is a good sample representing a population that is not beyond 10,000 respondents. They also claimed that 10% of the population is enough to be used as the sample. The study will use 25% which is as compared to the 10% with a sample of 100 SMEs. The phase of study covered 5 years from 2012 to 2016.

### **3.5 Data Collection**

Secondary data collection method was used. The data was obtained from the available financial statements of SMEs.

### **3.6 Data Presentation and Analysis**

The collected data was edited for correctness, reliability and comprehensiveness which will then be approved for coding and tabulation for ultimate scrutiny. It was then analyzed to produce vivid statistics such as percentages, means and deviations. The data was presented using tables, and cross tabulations.

The linear regression model was put in place to test the link between the variables of financial management practices as the independent variables and financial performance as the dependent variable.

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

Where:

$Y$  = Financial performance the Return on Equity (ROE) which is the net income divided total equity capital

$X_1$  = Current ratio

$X_2$  = Debt to equity ratio

$X_3$  = Asset turnover ratio

$X_4$  = Size (the natural log of sales)

$\beta_0$  = Constant and  $\beta_1, \beta_2, \beta_3, \beta_4$  are regression coefficients

$\epsilon$  = Error term

The error is the difference between the computed dependent variable value and the actual value.

Financial performance is usually indicated in ratios form and they cover a number of models which are clustered as firms' ability to make profit, efficient use of assets and investment. Financial performance in this study is the dependent variable was measured by the ratio of net profit to the total assets. The study made the use of the profits that are accrued by the SMEs in a period within which the study was conducted to measure the financial performance. Moreover, financial performance was also measured using mean and standard deviation to study the aspects related to financial performance. The independent variables are the financial management practices are the asset turnover, the size of the business, the debt to equity ratio the liquidity ratio and the current ratio

The coefficient of determination, R squared, tested the meaning of the regression model in elaborating the link between financial management practices and financial performance. R squared calculated showed the percentage variance in the dependent variable that is explained by the independent variable(s). If the R squared high then the model used is good. The analysis of variance (ANOVA) statistics was used for presentation of the regression model significance.

### **3.7 Data Validity and Reliability**

Describes to how well the result of a study can offer reliable results to the study question (Remenyi et al, 1998). To make sure there is validity, the information from earlier researches and different literatures which cover all the sections of the research will be used. Theoretical framework is a recap of earlier studies that have been conducted.



## **CHAPTER FOUR**

### **DATA ANALYSIS, RESULTS AND DISCUSSIONS**

#### **4.1 Introduction**

This chapter aimed at discussing the data analysis, findings and summary of significant findings in the study.

#### **4.2 Data Collection**

This study examined the financial management practices and the financial performance of the SMEs in Nairobi Central Business District. The population of study consisted of 398 SMEs. Data was collected from a sample of 100 small and medium enterprises the data was obtained from 70 businesses that has the financial statements prepared in a period of five years. This was a 70% response. Rahman and Ramos (2013) noted that a fifty percent response rate of was good for analysis and for reporting and a 70% rate and over was excellent.

#### **4.3 Data Validity**

The data which was sought on the financial statements that were available, in complete form as needed. This data includes debt, current assets, noncurrent assets, noncurrent liability current liability, sales and expenses to come up with the net profit for the particular years and was adopted for this study.

#### **4.4 Descriptive Statistics**

Table 1 provides the results of the descriptive measures the study used. They include the mean and the standard deviation.

**Table 1: Descriptive Statistics**

	Mean	Std. Deviation	N
ROA	0.9830	.2339	350
Size	0.2155	.39518	350
CurrentRatio	0.6805	.98469	350
DebttoEquity	0.6250	.67834	350
AssetTurnover	0.3892	.78294	350

The results in table 1 show that ROA has a mean 0.9830 a deviation of 0.2339 and of Size has a mean of 0.2155 and a deviation of 0.39518 current ratio has a mean and a deviation of 0.06805 0.98469 respectively. Debt to equity ratio has a mean and a deviation of 0.625 0.67834 respectively. Asset turnover ratio has a mean of 0.3892 and a deviation of 0.78294. Current ratio has a less relation to the performance with 0.98469 deviations as compared to size with 0.3952 deviation

#### 4.5 Regression Analysis

The below regression analysis was used to define the relationship between the dependent and independent variables.

**Table 2: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
					R Square Change	F Change	df1
1	.794 <sup>a</sup>	.630	.597	.39573	.630	19.148	4

**Source: Research Data**

The table above R 0.794 representing a correlation coefficient between dependent variable (ROA) and the independent variables (i.e size, current ratio, debt to equity ratio and asset turnover ratio) indicating it's a strong correlation. Hence it's a strong indicator that the predictor can explain the variation in the ROA upto to 79.4%.Even with the correlation of determination of 59.7% also clearly explain the how well the model can explain the relationship.

#### 4.6.1 Analysis of Variance (ANOVA)

Table 4 indicates the results generated by the regression estimate on the analysis of variance for the study model.

**Table 3: Analysis of Variance**

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	11.995	4	2.999	19.148	.000 <sup>b</sup>
	Residual	7.047	45	.157		
	Total	19.042	49			

Source: Research Data

Table above indicates the regression models significance. An F-significance value of 19.148 and  $p = 0.000$  elaborated that there is a probability of 0.0% of the regression model to present a false information. Therefore, the technique used is very significant.

#### 4.6.2 Statistical Significance of Independent Variables

Table 5 shows regression coefficients estimating the linear relationship between independent and the dependent variable.

**Table 4: Regression Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	1.120	1.337		-.838	.046
Size	.439	.198	.278	2.214	.032
1 CurrentRatio	-.010	.011	-.082	-.892	.047
DebttoEquity	.021	.086	.023	.250	.048
AssetTurnover Ratio	-.456	.100	-.573	-4.542	.000

Source: Research Data

The table above shows that the constant is would be 1.120. The size, current ratio, debt to equity ratio and asset turnover ratio has a beta value of 0.439, -0.1, 0.021, -0.456 respectively.

This explains that the regression constant shows that when the independent variable (the size, current ratio, debt to equity ratio and asset turnover ratio) are zero the financial performance (ROA) is 1.12. This indicates that without the financial management practices the financial would be negative. The performance is increased by size by the factor of 0.439 with a p value of 0.032, debt to equity increase by a factor of 0.021 and a p value of 0.048 holding other factor constant. However current ratio and asset turnover ratio decreases the financial performance (ROA) by a factor -0.10 and -0.456 and p value of 0.047 and 0.000 respectively holding other factors constant.

$$ROA=1.12-0.01X_1+0.012X_2-0.456X_3+0.439X_4+\epsilon$$

#### **4.7 Discussion of Findings**

The core objective of the study was to establish the relationship between financial management techniques and financial performance small and medium enterprises in Nairobi CBD. Financial performance was the dependent where return on assets was used to. Financial management practices were the independent variables where current ratio, debt to equity ratio, asset turnover ratio and size were used. Size was measured using the natural log of the sales.

The research findings established that the financial management practices used as the independent variables can determine the financial performance the SMEs. These variables could explain 79.4% of the variations in profits of SMEs. This indicated that the regression model had power as all the variables could be explained by the model.

Mean represents either a value about which the data tend to center. The mean for ROA, current ratio, debt to equity ratio, asset turnover ratio and size were 0.9830, 0.6805, 0.625, 0.3892 and 0.2155 respectively.

As indicated in the model summary, Table 3 the findings indicated a statistically significant connection between Return on Assets and the independent variables. Table 4 indicated that the results are on the goodness of fit of the standard linear regression with the Return on Assets and the independent variables. The F significance value of p is less than 0.05 demonstrating that the model has a probability of less than 5% prediction and it was reliable to draw conclusions. The results in Table 5 shows the model coefficients and it indicates that all the indicators of Return on Assets were significant

From the study, outcomes indicate that the relationship between the return on asset as the performance and the current ratio, debt to equity ratio, asset turnover ratio and sizes as the management techniques are significant with a  $p < 0.005$ .

The main suggestion for the study was that there exists a statistical significant relation involving Return on Assets and the financial management practices. The result of the study therefore does not the null hypothesis. There exists a relationship between the financial management practices in the small and medium enterprise in Nairobi CBD.

## CHAPTER FIVE

### SUMMARY, CONCLUSION AND RECOMMENDATION

#### 5.1 Introduction

The objective of the study was to determine the relationship between financial management practices and financial performance of small and medium enterprises in Nairobi CBD. This chapter is a synopsis of the discussions and findings stated from the previous chapters. Significant findings are summarized, conclusions drawn, recommendations made to policy makers in addition to further recommendations on opportunities for future research.

#### 5.2 Summary of Findings

Financial management goes beyond the activities of bookkeeping records. It is the vital division of business organization and can't be regarded as a different function to be left to finance staff or the group treasurer. Successfully managing financial resources is significant in developing as well as expanding businesses; therefore the management should ensure that there is thorough development and implementation of financial plans to ensure the organization achieves its ultimate goal. From the findings, the study found that lack of financial management practices by the SMEs would lead to poor financial performance holding all other factors constant.

The research findings presented intense information of the variables used in the data scrutiny. These variables were the Return on Assets, size, current ratio, debt ratio and asset turnover ratio. The results of the study concluded that there was an existing connection within the performance computed using ROA and of financial management practice as calculated using the ratios

The study also shows that not all the SMEs practice the financial management practice and for those that practice not all comply with the simple accounting standards. This led to a decrease of the data collected of 70 from a sample of 100. From the regression model a positive is observed correlation of return on assets and size and also current ratio. However there exists a negative relation with the asset turnover and the current ratio. Analysis of variance (ANOVA) results show that the regression has a sum of squares 0.11995 with a residual of 7.047 compared to a mean square of 0.2999 with a residual of 0.157. The results produced an *F*-significance value of  $p < 0.021$  which is below 0.05.

### **5.3 Conclusions**

The study sought to determine available link between financial management practices and financial performance of the SMEs in Nairobi CBD. The research findings portrayed that there was a weak relation that exists among the financial management techniques and financial performance of SMEs. The debt to equity ratio current ratio asset turnover ratio and size represented the financial management practices while return on assets represented financial performance. The ratio is of benefit to investors for it helps them to recognize the rate of risk for firms and the effectiveness of the operations therefore making investment decisions. In their study, Saeedi and Mahmoodi (2011) noted that financial leverage was positively associated with financial performance as measured by return on assets (ROA). The findings of this study contradicts with the conclusion made by Saeedi and Mahmoodi.

Assets are usually used as collateral for borrowing debt by firms. When Assets are used as collateral considers the liquidity level of the asset in terms of it being converted to cash because assets with high liquidity assets increase a firm's availability to debt financing. Debt to equity ratio determine the amount invested by the owner and the

amount borrowed from financial. The size is the determinant of how the sales are made by the business. The asset turnover ratio determines the effective the business uses its assets to generate profit. This in turn the earnings from this income generating asset may be ploughed back in the firm investments leading to improved performance. However, a firm may use this income generating as collateral for debt financing on the basis of their liquidity.

The return on asset will assist the management to properly advise the managers on ways to enhance their investment portfolio, in addition to accessing the required loans, and also provide a competitive edge within the industry

#### **5.4 Policy Recommendations**

The study found that some of the SMEs has adopted financial management practices in their businesses which makes their business prone to expected business risks and some inefficiency. It is recommended that awareness be created by policy makers to the SMEs on the importance of the financial management in business operations. The accounting and finance professions should ensure that the entrepreneurs have the basic knowledge of financial statement preparation in order to assess their financial activities. The study established that most of the SMEs do not prepare financial statements and less that prepare do not adhere to the standards. This has rendered the enterprises unable to determine their progress and also to monitor their cost expenses. It is recommended that SMEs adopt the culture financial statements and creation.

The study found that financial statement and financial management practices in most of the SMEs is not automated. This exposes the business to human errors and inaccuracies which would have been avoided if technology was used. The study recommends use of technology in financial statement for ease of financial management processes.

#### **5.4.1 Recommendations for further studies**

The study collected data from the SMEs which are operating in Nairobi CBD the research could be done to compare with other towns. The study can also be done to relate the financial management and financial performance from case study or industry. The study proposes that similar research to be done on the effect of the financial planning practices on other indicators of business performance such as sustainability, market share and customer retention.

The study recommends that the same kind of study be done on the large enterprises which have different practices and use different strategies to determine their achievements.

#### **5.5 Limitation of the study**

The study was able to identify following limitations as below:

The study was limited to SMEs that are surviving as at the time of the study thus failing enterprises were not considered.

Secondly, the study findings are difficult to compare due to differences in the SMEs in terms of enterprise type, industry or time in operation. Therefore it would be motivating to examine whether there are differences in the degree of financial management with regard to industry affiliation.

Lastly, the time frame of 5 years within which study was based and therefore the results may not be comprehensive and conclusive enough if SMEs that have operated for more than 5 years or less than 5 years were studied.

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### APPENDIX 1. SECONDARY DATA

Variables Business	Current Asset	Non- current Asset	Current Liability	Non- current Liability	Deb t	Equit y	Sales	Expenditure
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
“								
“								
“								
100								

## APPENDIX 2: LIST OF SMES IN NAIROBI

- 1) Advantech Consulting ltd
- 2) African e-shop
- 3) Afro Forex Bureau
- 4) Ahead Technologies Ltd
- 5) Air Afrik
- 6) Airfall cooling services
- 7) Alihito Agency
- 8) Amak computers
- 9) Amana Capital Ltd
- 10) Amazon Forex
- 11) Amex Forex Bureau
- 12) Apex Lifestyle consulting
- 13) Aristocrats Forex
- 14) Arkim stars Ltd
- 15) Bay Forex
- 16) Beauty Wholesale K Ltd
- 17) Biashara Africa Lmt
- 18) Biashara Coach and Mentor
- 19) Biz Brokers Kenya
- 20) Blue Nile Forex
- 21) Briantony International Consultancy
- 22) Bright Startups
- 23) Bringent consulting
- 24) Brisk trading
- 25) Bruceward consultancy
- 26) BTL Consulting Ltd
- 27) Cannon Forex Bereau Ltd
- 28) Cape Equitorial Group Co
- 29) Capital Bereau De Change
- 30) Card and Craft Collection
- 31) Central Wholesalers
- 32) Cinerama
- 33) ClimateControl Engineering
- 34) Colorado Trading Co
- 35) Continental Forex Bureau Ltd
- 36) Cyan Office Supplies
- 37) Dahabshill Forex
- 38) Demo Entertainment
- 39) Deprime Solutions
- 40) Doc&Data Enterprise
- 41) Dodhia Traters (K) Ltd
- 42) Dorro Trading Co
- 43) EAR'ls Trading Co Ltd
- 44) EBCO Warehouse Ltd
- 45) Edarns Enterprise Ltd
- 46) Essential Innovative Synergy Africa
- 47) Fair dealing Forex
- 48) Finance and Systems
- 49) Future soft technologies
- 50) Giovani Enterprise
- 51) Growth partners
- 52) Halisi Group
- 53) Hudistand Spice mill
- 54) Icepay Busine ss Solution
- 55) Jash Agencies
- 56) Joint Procurement ventures
- 57) Jopet Ltd
- 58) Kenya National Trading Corporation  
Ltd
- 59) Kiutha Trading Co Ltd
- 60) Kuzabiashara
- 61) Leading Edge Food & Enterprise Ltd
- 62) Links & Knots Ltd
- 63) Lucky's International Ltd

- |                                      |                                  |
|--------------------------------------|----------------------------------|
| 64) Mansikh Trading Co               | 83) SME Kenya                    |
| 65) Mitsui & Co Ltd                  | 84) Socio Trading Co Ltd         |
| 66) Moneypoint Forex Bureau Ltd      | 85) Soko huru                    |
| 67) Nelson Ngethe & Son              | 86) Southlink Trading Co Ltd     |
| 68) Nikohapa Ventures                | 87) Speedy Exchange Bureau       |
| 69) Offshore Forex Bureau Ltd        | 88) Sterling Forex Bureau Ltd    |
| 70) Ohala Classified                 | 89) Taylorea                     |
| 71) Old MarkSoap Factory Ltd         | 90) Tender Base Ltd              |
| 72) OneSource Financial Services Ltd | 91) Tentel Trade & Supplies Ltd  |
| 73) Pacific Firm Ltd                 | 92) T-Lynk Enterprise            |
| 74) Pacific Forex Bureau Ltd         | 93) Tomen Corp                   |
| 75) Pinnacle Forex Bureau Ltd        | 94) Top Rank Trading Co          |
| 76) Planet Connection Ltd            | 95) Triple EPE Foundation        |
| 77) Power Brands Limited             | 96) Unique Slim Point & SPA      |
| 78) Rahito Trading Co                | 97) Urban Properties Consultants |
| 79) Razfar Investment Ltd            | Developers Ltd                   |
| 80) Savislinks technologies          | 98) Viffa consult ltd            |
| 81) Savvy Concepts                   | 99) Wallpaper Kenya              |
| 82) Sky Forex Bureau                 | 100) Wellspa Ltd                 |

**Source: Kenya Business List**

# Map of Nairobi CBD

