Research Paper

African Journal of Commercial Studies
Peer Reviewed Journal

Volume - 1, Issue - 1, Sep-Dec 2022 | pp 9 – 17
Article ARK: ark:/69431/AJoCS.v1i1.2

Challenges Affecting Financial Performance of Small and Medium Sized Firms in Kenya

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Abstract: *Financial performance, in a broader sense, refers to the extent to which a firm's financial objectives have been met. This study aimed to evaluate the obstacles impacting small and medium-sized firms' financial performance in Kenya. The study's foundation was the body of existing literature, particularly on the variables affecting performance in small and medium-sized businesses, which was used to pinpoint these difficulties. The study's descriptive survey design was used. Nine hundred and eighteen businesses answered questionnaires from the researcher. To gather primary data for this study, standardized questionnaires were used. The collected data were subjected to correlation analysis, with the findings presented using scatter diagrams. The study established a positive linear relationship between the financial performance of SMEs and each of the variables: capital adequacy, human resources commitment, and customer loyalty.*

Keywords: Financial Performance, Capital adequacy, Human Resources commitment, Customer loyalty

1. Introduction

Financial performance is a crucial component of managing financial risk and refers to the extent to which financial objectives are being or have been achieved. It is the process of calculating the monetary value of the outcomes of a firm's policies and operations. It is used to assess a company's overall financial standing over a certain time period and may also be used to compare similar companies within the same industry or to aggregate industries or sectors.

Measuring a company's financial performance entails calculating the financial impact of its operations and policies. Financial performance is a broad indicator of a company's overall financial health over a specific time period (Hunjra & Bashir, 2014). The firm's return on investment, return on assets, value created, etc. represent these outcomes. Financial performance is a gauge of how effectively a company can utilise resources from its main line of business and generate income. This phrase is frequently used to compare similar businesses within the same industry or to compare whole industries or sectors. It can also be used as a broad indicator of a company's overall health during a specific time period.

According to World Bank (2015), Small and medium-sized businesses (SMEs) are extremely important to most economies, especially those in emerging nations. In emerging economies, formal SMEs can account for up to 33% of the GDP and up to 45% of all employment. When informal SMEs are taken into account, these figures are substantially higher.

SMEs rely on internal or "personal" money to start and run their businesses in the beginning because they are less likely than large companies to be able to obtain bank loans. 50 percent of legally recognized SMEs lack access to formal credit. When micro and informal businesses are taken into account, the financial gap becomes even more. The majority of small and medium-sized businesses in emerging markets—roughly 70%—do not have access to loans (World Bank , 2015). For many years, SMEs' access to financing, particularly in low-income areas, has been a major cause of concern. This issue has been greatly resolved by the utilization of digital credit (Kamau, 2021). A review of your financial performance can help you reassess your business goals and plan effectively for improving the business.

Internal resources, debt, and financial markets are the three main sources of funding for small and medium-sized businesses (Maurel, 2008). A major barrier to the growth of small and medium sized businesses might be a lack of financial resources.

Africa's financial systems, according to Beck and Cull (2014), are constrained, expensive, shallow, and have little reach. The use of formal financial services as measured by firm and household statistics as well as overall financial development indicators reflects this. However, the market structure and stability of African financial systems have undergone significant changes during the past 20 years. And there are significant differences across the region, ranging from deep banking systems that only provide the most basic financial services in underdeveloped nations like the Central African Republic and South Sudan to well-developed financial systems in middle-income countries like Mauritius and South Africa.

In Kenya, Kamau and Kalio (2012) found a link between the amount of interest levied on MFI loans and the loans' fairness and affordability as a result of the interest. This implies that loans to SMEs become less affordable the higher the interest rates. Their analysis also showed a negative association between business performance metrics and the level of interest rates levied on loans by MFIs. According to the study's background information, small and medium-sized businesses in Kenya confront a variety of difficulties. The difficulties influencing the financial performance of small and medium-sized businesses in Bungoma County will be the focus of this study.

2. Problem Statement

Many companies are founded, but only a small number expand to become multinationals. The majority of newly launched firms are abandoned very quickly. This can be a result of the various difficulties faced by Kenya's small and medium-sized businesses.

Numerous research and official policy documents have acknowledged and highlighted the significance of MSEs in economic development. Fatoki and Asah (2011) assert that MSEs have a favorable impact on economic expansion, job creation, and the reduction of poverty. Since the relationship between finance and performance of small and medium-sized firms (SMEs) has drawn significant attention in finance literature, there has been a lot written about performance (Harash, Al-Timimi, & Alsaadi, 2014). Working capital is the process of managing an organization's short-term assets and obligations to increase profitability and prevent bankruptcy issues. In Kenya, the relationship between working capital management, liquidity, and financial success is crucial for small and medium-sized businesses when making decisions (Chasha, Kavele, & Kamau, 2022). In adequate capital base is cited as one of the challenges facing small and medium sized enterprises in Kenya today. Other challenges include high staff turnover and low customer loyalty

3. Theoretical framework

Mueller (1972), in his critique of growth theory, proposed the lifecycle theory of the business, in which he postulated that the age of the organization influences growth. The business life cycle theory of dividends is based on the idea that as a firm ages, its capacity for cash generation surpasses that of its capacity for identifying lucrative investment possibilities. At some point, paying dividends to shareholders using the company's free cash flow is the best course of action.

According to Mueller's (1972) description of the lifecycle of a firm, once a company has been operating for a while, rivals start to enter the market and start utilizing and building upon the innovations made by the pioneering firm. The firm's growth starts to slow down as fresh markets are harder to identify and saturated markets become more difficult to penetrate. The business must develop innovations to maintain growth and profitability. But as the company expands, its ability to analyze information declines, and the average manager's incentives to take risks are reduced. These elements restrict a major company's ability to develop new products and expand through innovation. This theory relates to this study since financial growth of the firm is somehow dependent on the firm’s age.

4. Concept Perspectives

The performance of commercial banks in Kenya is highly impacted by capital sufficiency, asset quality, and managerial effectiveness, according to Ongore and Kusa (2013). However, there is little evidence that liquidity has a significant impact on the performance of commercial banks in Kenya. It was discovered that there was a positive correlation between bank performance, capital adequacy, and management effectiveness, but a negative correlation for asset quality.

In this study, we develop a broad analytic framework for the funding issue facing small- and medium-sized businesses (SME). We discovered that the loan collateral, transaction costs, and the heterogeneity of SME risk are the main factors influencing SME financing in an economy with a highly concentrated banking industry. Second, we incorporate small-and-medium-sized financial institutions (SMFs) into the model under a few fundamental presumptions, and we theoretically demonstrate that doing so will boost loans to SMEs and improve social welfare. Additionally, we discover a favorable association between the SMF number, knowledge advantage, and loans to SMEs (Zhiyun, 2002). The degree of awareness of cryptocurrencies is much higher than the level of participation among Kenyan SMEs (Kamau, 2022). This formation of small and medium sized financial institution has helped reduce transaction cost and the loan collateral, which are the major factors that affect the SME financing.

Small and micro businesses typically grow slowly or maybe not at all. It is anticipated that the company will suffer significant losses in its early stages before succeeding later in its life cycle. The advent of Covid 19 caused the system to become more complicated. The availability of financing, the cost of financing, and business success for SMEs in Kenya are typically correlated (Kamau, 2021). Every business that has an objective to expand from being a small medium sized enterprise to a multinational, the management should ensure that there is adequate capital all the time, there is human resource management and at last they should promote customer loyalty all the time

Variable Measurements

All organizations have goals to achieve. One of the objectives is profit maximization, for an organization to achieve this objective; they have to deal with the challenges influencing financial performance which include: -

Adequacy of capital - For any organization to maximize its profit it must have adequate capital, this capital will be used in production, marketing, purchasing fixed assets and hiring human resource. With inadequate capital the organization will not meet market demand. There are two types of capital namely debt capital which is borrowed from financial institutions and equity capital which is owners' contribution. Adequacy of capital is measured using Debt Equity Ratio, Profit to Capital Ratio, Fixed assets ratio

Human resource commitment - Labour is a factor of production and it is offered by human beings. Labour can be increased or reduced. The commitment of human resource is a factor of financial performance and it can be measured by: Number of staff / number of employees, the more the employees the high the rate of production because if the enterprise has many employees it shows that it can cater for their expenses and it shows that the firm is making profit.

Level of remuneration is the reward for labour and the high the remuneration the more the commitment of employees to the work and the low the level of turnover. Staff turnover is the rate at which the employees lave the enterprise. The low the turnover the more the commitment and the high the turnover rate the low the commitment to the work. This rate of staff turnover can be measured by the period of time the employee has worked in the organization. Low staff turnover will improve efficiency and increase level of production

Customer Loyalty - It is the number of customers who are loyal and confident with the enterprise. It means that every time they need a product, they will always get it from the firm no matter the cost. To measure customer loyalty, we have to access Market share is the area of operation and the branches of the enterprise have opened in the area. If in the area of operation, the enterprise has many branches then it has many loyal customers. Sales Turnover is the rate of sales turnover clearly shows whether the customers are loyal or not to the enterprise. The high the sales turnover the more the customer's loyalty. Customer feedback efficiency is experienced whenever the customer's gives feedback on the products whether positive or negative and this shows that they are loyal to the enterprise

Financial Performance - It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. This is measured by Return on Investment, Net Profit Ratio, Acid Test Ratio.

5. Methodology

The study targeted assorted SMEs in Kenya. From the sample of nine hundred and ninety eight questionnaires dispatched to the respondents, nine hundred and eighteen questionnaires were administered satisfactorily and returned. Eighty questionnaires were not returned. This represents 92% response rate. Hence concluding that the overall response rate of the sample size was 92% responded while 8% did not respond. The data collected was subjected to correlation analysis and the results were presented in form of scatter diagrams.

6. Correlation Analysis

Scatter diagrams were drawn in order to assess the relationship between the various variables. The results were as explained in the subsequent subsections.

6.1 Financial performance vs. Capital

The scatter diagram was drawn to show whether there was a relationship between the SMEs profitability with the capital adequacy.

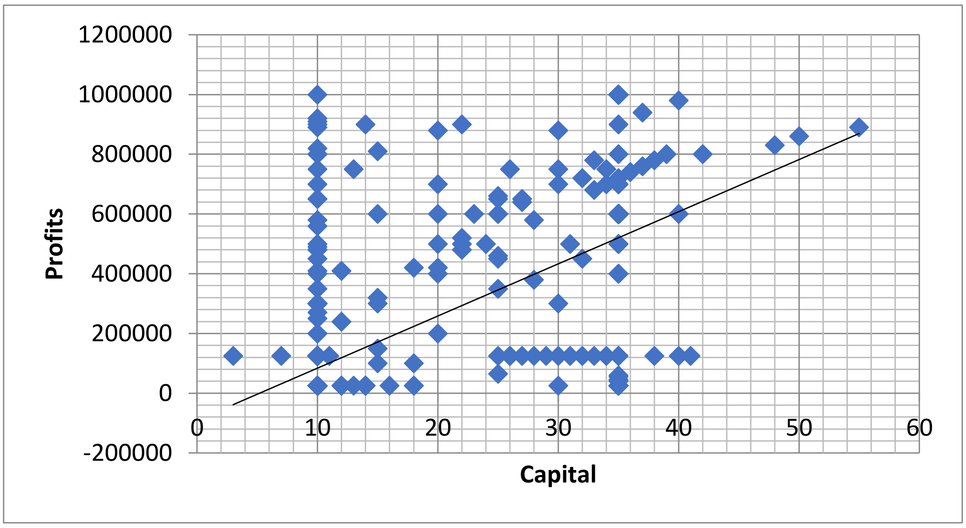

Figure 1 Scatter Diagram on Profits vs. Capital

Figure 1 above indicates that there was a positive linear relationship between capital and profits. This implies that the higher the capital, the higher the profits of SMEs. This graph helps the researcher to answer the first research question and the first research objective. The two sought establish if there was a relationship between financial performance and the capital.

6.2 Financial performance vs. Human Resources Commitment

The scatter diagram was drawn to show whether there was a relationship between the SMEs profitability with the human resources commitment.

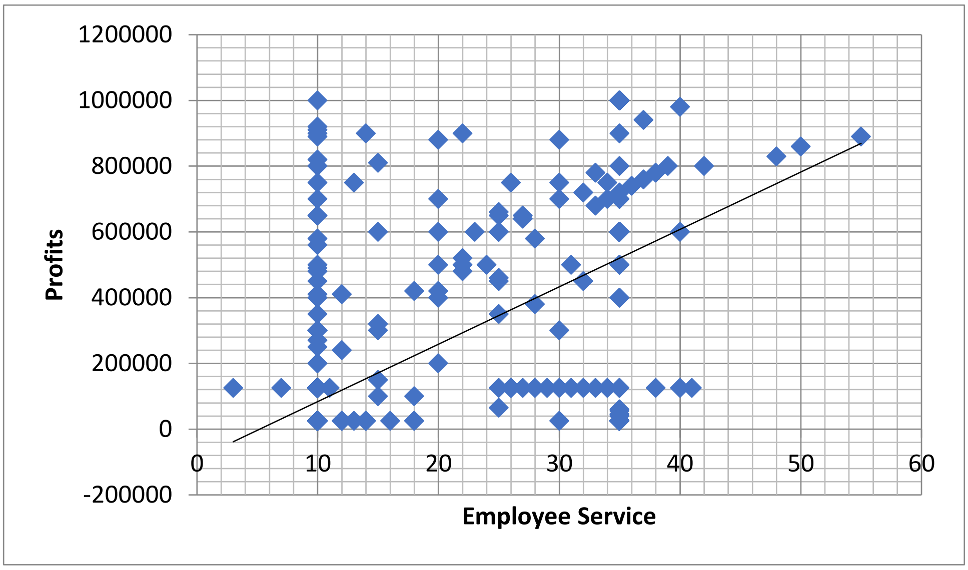

Figure 2 Scatter Diagram on Profits vs. Human Resources Commitment

Figure 2 above indicates that there was a positive linear relationship between human resources commitment and profits. This implies that the higher the length of employee service, the higher the profits of SMEs. This graph helps the researcher to answer the second research question and the second research objective. The two sought establish if there was a relationship between financial performance and human resources commitment.

6.3 Financial performance vs. Customer Loyalty

The scatter diagram was drawn to show whether there was a relationship between the SMEs profitability with the customer loyalty.

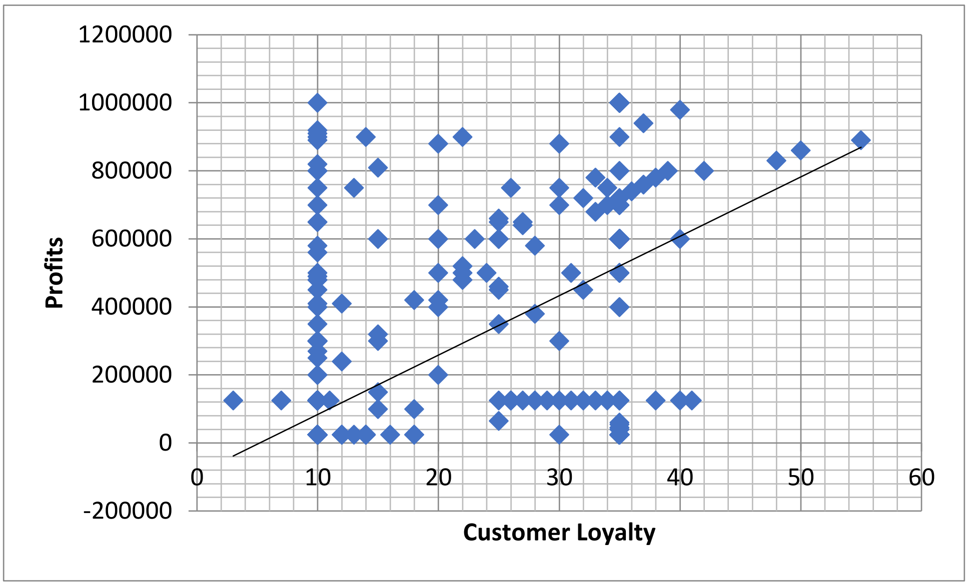

Figure 3 Scatter Diagram on Profits vs. Customer Loyalty

Figure 3 above indicates that there was a positive linear relationship between customer loyalty and profits. This implies that the higher the number of loyal customers, the higher the profits of SMEs. This graph helps the researcher to answer the third research question and the third research objective. The two sought establish if there was a relationship between financial performance and customer loyalty.

7. Conclusions

Based on the results of this study, financial performance of SMEs was affected by the adequacy of capital, human resources commitment and customer loyalty. Each of the factors had positive influence on the financial performance of SMEs. Financial performance of SMEs is also affected by other factors such as poor record keeping, poor access to loan facilities, high labour turnover and poor management strategies.

After thorough analysis of the findings of the study, the researcher recommends that proper records should be kept to ensure that the financial performance is easily measured and monitored. small and medium sized enterprises should reduce the cost like costs. Of recruiting new staff and training costs that arise due to labour turnover. Small and medium sized enterprises should major on promoting public relations of its enterprise and this will increase customer loyalty. The government should support small and medium sized financial institutions that offer loans to small and medium sized enterprises and this will reduce capital inadequacy

The researcher suggested that this area needs a lot of probing and further research since the challenges affecting financial performance of small and medium sized enterprises are inexhaustible apart from the ones laid down in this study. this study cannot be termed as exhausted because the tested hypothesis dealt on only with three variables and other variables needs to be researched on.

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