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The Nexus Between Working Capital Management Practices and the Financial Performance of Service Sector Small and Medium-sized Enterprises (SMEs) in Nairobi City County, Kenya

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Abstract

Working capital management practices play key roles in the financial performance of organizations. Firms that endeavor to enhance their financial performance strategize on working capital management to improve on cash flow management and earnings quality through efficient use available resources. Scholarly interest on how SMEs can enhance their financial performance through effective working capital management practices has continued to increase due to the significant contribution of the service sector SMEs to the growth of economies around the world. Nevertheless, empirical research linking working capital management practices and the financial performance of service sector SMEs in Nairobi City County is inadequate. The current study sought to investigate the nexus between working capital management practices and the financial performance of service sector SMEs in Nairobi City County, Kenya. The study was anchored by two theories, including, capital budgeting theory and the pecking order theory. The study adopted a correlational research design and targeted a population of 4,857 SMEs owners, managers, or their equivalents from which a sample of 370 participants were selected to participate in the study. The Statistical Package for Social Sciences (SPSS) was used to analyze descriptive and inferential statistics. The study findings confirmed a positive and statistically significant relationship between working capital management practices and the financial performance of sector SMEs in Nairobi City County, Kenya. The study findings may be helpful in informing favorable policy formulation and economic environment conditions that the county and national government can provide to SME firms for enhanced performance.

Keywords: *Working capital management practices, financial performance, service sector, SMEs, Nairobi County.*

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1. Introduction

Small and medium-sized enterprises (SMEs) have been considered as a solution for promoting economic growth and job creation throughout the world. Jennifer and Dennis (2015) reported that many people are employed by small and medium-sized businesses (SMEs), particularly in developing countries. The SME sector is a source of employment for about 4.6 million people, accounting for 75% of all businesses, and provides 30% of all jobs. The sector generated 87% of the nation's new jobs in 2016 and increased the GDP by 18% (Kieu, 2017). The majority of small and medium-sized businesses (SMEs) have more than 10 employees but fewer than 500 (Ahn et al., 2015). Europe has the biggest number of SMEs, with the majority of companies employing between 10 and 49 workers and barely a tenth solely employing between 50 and 249 workers. These small and medium-sized enterprises (SMEs) play an essential part in the European economy by providing work for around 100 million people (Clark, 2020). Such a contribution makes them the primary contributors to the expansion of the European economy.

According to Kinyua and Mungai (2018), strong financial management practices enable businesses to implement sound policies that would assist them in achieving their performance goals. Practices such as management of assets and supply chains are included in this category. According to Kamande (2015), the majority of small and medium-sized enterprises (SMEs) encounter difficulties in implementing appropriate financial practices and making effective use of financial resources. Thus, the possible failure to manage working capital effectively may cause financial performance recessions in SMEs.

Several residents in Nairobi County depend on small and medium-sized enterprises (SMEs) for their income. SMEs are responsible for the creation of many new jobs as well as the maintenance of an effective supply chain for goods and services. Generally speaking, the law requires the proprietors to make tax payments. According to Porter and Kramer (2019), the initial action to take in adopting effective methods of working capital management is to keep accurate books of accounts. However, most SMEs adopt simple strategies for financial management due to lack of resources to engage the services of bookkeepers and experienced managers for the mentioned strategies. Moreover, the growth of SMEs has been hampered by a lack of strong financial management practices and this may affect their performance.

In order for businesses to increase their working capital, they should engage in the practice of investing in current assets (Kipsang et al., 2016). This virtuous habit enables a company to check its current assets and current obligations in order to keep its liquidity in check. Furthermore, although accountability and inflation play an essential role in financial management practices as moderating factors, many research have neglected to delve into the important features of their influence on independent and dependent variables (Noori et al., 2022). This is despite the observation that both accountability and inflation play a crucial role in designing the practices for managing firms' finances.

Problem Statement

Small and medium-sized businesses (SMEs) are crucial to the economic growth of many nations (Isaga, 2015). Kenya has gained a lot from the expansion of the small and medium-sized business

sector. Over 4.6 million people (more than 30%) of the workforce in the country work under the SME sector. Currently, the SME sector has about 75% of all businesses being operated in the country (Mwanika, 2020). Additionally, the SME sector generates 18.4% of the GDP and is responsible for 87% of employment opportunities in Kenya's economy (Mwanika, 2020). Despite being crucial to the growth of the economy, the industry frequently falls short of expectations. The growth of SME in Kenya fell from5.6% in 2016to4.7% in 2017 (KNBS,2018). Three out of five enterprises fail within the first few years of existence, as noted by Oluoch (2020). According to Njue and Mbogo (2017), such impacts result in the loss of jobs, as well as in stability, social inequities, and a reduction in economic growth.

In response to the challenges facing the SME sector, the government has taken steps to create employment possibilities, especially for the young people who constitute 65% of the population, in an effort to encourage economic growth. Funds dedicated specifically to youth empowerment include the Youth Fund, Uwezo Fund, and Hustlers Fund, and 30 percent of all government contracts are set aside for young people to bid on (Odhiambo, 2023). However, extant empirical evidence shows that three out of five SMEs in Kenyan fail even before the first quarter is up whereas very few manage to realize a ROA above 20% (KNBS, 2018).

Past studies have not adequately elucidated the nexus between capital working management practices and the financial performance of service sector SMEs in Nairobi City County. For example, the financial success of Kenyan insurance companies was found to be strongly positively correlated with important financial management techniques, according to Milkah (2014). However, the causes of this relationship are yet unknown, necessitating additional research. Similar to this, Nyongesa (2014) looked at the financial management of Kenyan insurance firms and found a strong correlation with their success. However, more study is necessary to comprehend the underlying causes. In their study on the growth of SMEs in Kenya, Ngugi et al. (2013) discovered conflicting data about the influence of financial management strategies on organizational effectiveness. Additionally, Bendavid Herer and Yucesan (2017) underlined the dearth of studies concentrating on certain industries and emerging economies. The objective of this study is to bridge the gap in existing literature about the effects of Investment decisions, Financing decision and, Working Capital Management on financial performance of SMEs in Embakasi-East.

Aim

The study aimed to investigate the nexus between working capital management practices and the financial performance of service sector SMEs in Nairobi City County, Kenya.

Significance

The study findings provided crucial insights to financial providers and banks, investors, SME owners, government policymakers, and researchers and academicians by increasing their understanding of the nexus between working capital management practices and financial performance of service sector SMEs in Nairobi County, Kenya.

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2. Literature Review

Theoretical Review

The theories that underpinned the study included capital budgeting theory and the Pecking Order theory.

Capital Budgeting Theory

In Peter J. Dickerson's 1963 capital budgeting theory, key evaluation metrics like net present value (NPV), internal rate of return, weighted average cost of capital (WACC), and payback period play a crucial role in assessing capital expenditures. The ultimate aim, as highlighted by Woods and Randall (1989), is to maximize shareholder wealth, with NPV being a common tool measuring it. However, the theory has faced criticism for potentially favoring long-term future investment opportunities (FIOs) over shareholder interests. The suggestion to discount at the required return on equity (KE) instead of WACC for FIOs is presented. Criticisms include the irreversible nature of long-term investment choices, reliance on estimations and assumptions, and subjectivity in risk assessment. Despite challenges, the theory underscores the importance of thorough analysis in capital budgeting for responsible decision-making and long-term business viability.

The Pecking Order Theory

Both Donaldson and Mayer and Majluf are credited with the theory's development (Mayer & Majluf, 1984). When picking the means of financing, businesses should, in accordance with this Pecking Order Theory (POT), adopt a pecking order, beginning with their own internal finances and working their way upto seeking equity from outside sources only as their last option. Ngugi et al. (2013) claim that the pecking order theory guides firms on the optimal capital structure (internal, debt, and equity financing) that firms should have. The theory views that managers begin by making use of retained earnings before considering debt and equity.

Allini et al. (2018) recommended that the firm should follow an ordered list of options in order to maximize their chances of securing those funds. The basic proposition provided by the POT is that the financing order should start from debt, then go to convertible instruments, followed preferred stock and finally common stock. If this recommended order is followed, the company will be able to efficiently manage its funding requirements and reduce the costs that are associated with the issuing of shares. Thus, the theory presents the possibility of avoiding exhibiting unfavorable reactions to market conditions, especially when accessing additional equity, which will lead to lower expenses of equity if it is implemented.

According to Schulze et al. (2015), the POT offers firms increased fiscal security and adaptability while preserving its capacity to adjust to the ever-shifting dynamics of the market. The pecking order theory provides a framework to grasp the dynamics of the funding decisions and provides significant insights into the elements that influence a company's capital structure.

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Empirical Review

Boisjoly et al. (2020) studied the longitudinal impact of aggressive working capital management practices on various elements of financial performance, including the cash conversion cycle. The study used data spanning 1990 and 2017 from various industries to determine the empirical effect of the practices. The study findings confirmed that effective working capital management practices are the foundations of improved profitability. Although the study was not based on primary data and the context of a developing country, it provided essential background of the relationship between working capital management practices and financial performance. The current study intended to test whether the relationship can hold in developing contexts like Kenya.

Alvarez et al. (2021) intended to investigate the influence of working capital management on the profit levels of Argentine-based manufacturing firms. The study was based on the core theoretical framework that the literature suggests. The authors noted that several studies have attempted to address the relationship between working capital management and profitability of firms, but studies have not adequately focused on emerging economies. The sampling technique that the study used was stratified, which was based on an economic criterion. Data analysis results using a fixed-effects regression model revealed that there is a significant relationship between the components of working capital and firms' profitability. One of the strengths of the study was using longitudinal data that spanned three years, generating robust findings. Nevertheless, the study did not apply primary data that could generate first-hand information from live participants. Such data could improve the quality of the study results and increase its effectiveness in decisions making.

Nurein and Din (2017) examined to what extent working capital influenced the business financial restrictions and accomplishment in SME and listed businesses operating in Bursa, Malaysia. The findings show a positive relationship between performance and budgetary restrictions when it comes to the choice of working capital. A company with fewer financial restraints can function better than one with more. According to the study, for a firm to maximize shareholder value, it is necessary to formulate and improved working capital policy that has an extended net trade cycle. However, it did not thoroughly examine other factors, including macroeconomic conditions, firm-specific features, or industry-specific traits that may play a role in influencing this association. Additionally, the study's particular emphasis on businesses situated in Bursa, Malaysia, may have restricted the findings' applicability in other situations. Therefore, additional research is required to provide a more thorough understanding of the elements that affect how working capital practices, financial limitations, and performance relate to one another in various industries and geographical regions.

Oluoch (2016) conducted a study to examine how cash management techniques affect business profits in the Eldoret CBD. This study's theoretical approach was derived from liquidity theories, which contend that effective cash management practices enhance an organization's performance. To gather the necessary data for the study, questionnaires were distributed to a cross-section of the population. The data was analyzed using descriptive and inferential statistics. It was found in the research that effective cash management strategies contributed extensively to corporate success. the It's essential to keep in mind, though, that the study was limited by its geographic emphasis and reliance on self-reported data from questionnaires. To validate the findings in various contexts and by utilizing alternative research approaches, more study is required.

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Conceptual Framework

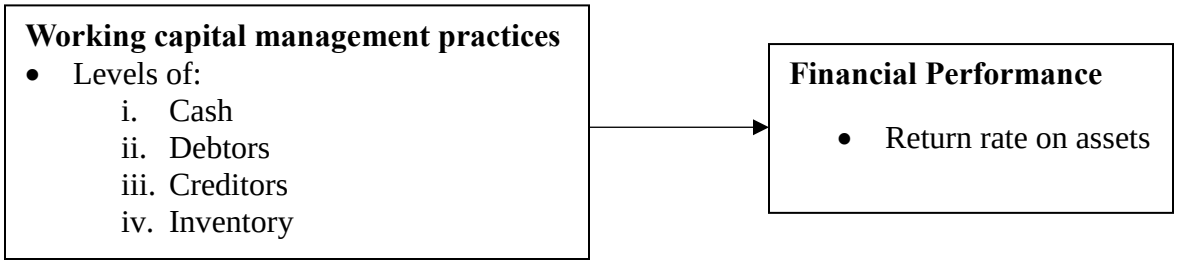

Figure 1: The conceptual framework

The conceptual framework presents a hypothesized relationship between working capital management practices and the financial performance of service sector SMEs in Nairobi City County, Kenya.

3. Methodology

Research Design

This study applied a correlational research design to examine how financial management strategies affect the financial performance of small and medium-sized businesses (SMEs) in the services sector in Nairobi City County, Kenya. With a correlational research design, it is possible to gather data on current events and other pertinent phenomena and utilize that data to draw valid conclusions about relationships between variables (Yin, 2017). The design was appropriate because it limits the amount of human intervention while making it easier to identify how study factors are related.

Study Location

The location of the study was Nairobi City County. The county was chosen because of the extensive SME activity within the region. Nairobi City hosts the highest number of small and medium-sized enterprises (SMEs) compared to all cities in Kenya. The county issues a wide variety of permits depending on criteria like square footage and staff size.

Population and Sampling

Approximately 4,857 business owners, managers, or equivalents made up the study's sample population. These people have been chosen as the primary research subjects because they play an integral role in the daily operations of the SMEs and have the necessary expertise in the area under investigation. As of December 2022, there were a total of 57,340 licensed SMEs in Nairobi County, “with 4,857 of them operating in the service sector” (Nairobi City County, 2022).

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Table 1: Target Populations

	Category	Frequency	Percentage
01	SMEs Owners	3,400	70
02	Managers	1,457	30
	Total	4,857	100

When conducting a stratified random sample, the population is initially separated into distinct, non-overlapping groups known as "strata" based on the factors of interest. A representative stratified population sample was assembled using a random selection of individuals from each stratum.

Taro Yamane's formula was used to determine how many people to include in the study's sample. Since a normal distribution is assumed by this formula, it works well. Hussey and Hughes (2007) propose a 10% tolerance for sampling error and a 90% confidence level as minimum requirements for a valid sample. Risk related to estimating population parameters were kept to a minimum by using a 5% sample error for this specific study.

Sample size was calculated using Yamane's formula, as shown below.

n= N/ (1+N (e) 2)

In the formula, n represented the sample size, N represented the population and e was taken as the level of precision (e=0.05).

To get the sample size, n=4,857/1+4,857(0.05)2 =370

The samples size was distributed to the owners and managers as shown in Table 2.

Table 1: Sample Size

Category	Population(N)	Percentage (%)	Sample Size
SMEs Owners	3,400	70	259
Managers	1,457	30	111
Total	4,857	100	370

Instrumentation

The study adopted a structured questionnaire to collect quantitative data. Prior to the use of the questionnaire for data collection, it was necessary to test it for validity and reliability. Achieving content validity required the researcher to consult with the supervisor, lecturers, and specialists. The consultation provided an opportunity to evaluate the questionnaire's appropriateness and make

sure it captures the right information. Cronbach's Alpha was applied to the data in order to determine the precision of the coefficients. The "computation of the Cronbach's alpha coefficient was helpful in determining how the items correlate with one another" (George & Mallery, 2018).

Data Collection Procedures

Primary data were gathered using self-administered surveys. Due to their clarity and anonymity, questionnaires are highly favored for collecting information directly from respondents. The standardized questions and responses in the survey made data collection a breeze. The Drop-Off/Pick-Up (DOPU) approach was used, in which questionnaires are sent out to respondents and collected later once they have been filled out. Higher response rates have been observed while using this strategy. To help with data collecting, the researcher hired research assistants.

Data Analysis Procedures

The process of analyzing the data required a number of phases, including cleaning the data, modifying the data, and coding. For the purposes of summarizing and describing the data, descriptive statistics such as means and standard deviations was utilized. In addition, the researcher executed multiple regression analysis to provide a basis for identifying the relationship between two or more variables. The information wase coded, and then thoroughly checked for any mistakes or omissions. To facilitate better comprehension, the findings provided in the form of frequency tables, percentage breakdowns, and graphs. In order to allow effective analysis, the responses that were gathered from the questionnaires were processed with the use of the SPSS software.

Multiple linear regressions were used to explore the underlying relationship that exists between the dependent variable (Y) and the independent variable (X). The following procedures were involved in this analysis:

$$Y=B_0 + B_1X + \varepsilon \quad \text{.....(i)}$$

In the equation, Y represents financial performance (dependent variable), X independent variable (working capital management practices). Moreover, B_0 stands for the intercept coefficient. B_1 is the coefficient of the independent variable (working capital management practices) and ε is the error term.

Research Ethics

The researcher drafted a cover letter that explained the scope of the research and guaranteed the privacy and security of all participant information. The approval letter from Kenyatta University and NACOSTI license were also presented during the study.

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4. Findings

Response rate and Reliability

The study achieved a 96.49% response rate as shown in Table 3.

Table 3: Response rate

	Frequency	Percentage
Number of questionnaires issued	370	100%
Number of questionnaires returned	357	96.49%
Number of questionnaires not returned	13	3.51%

The sample size target was 370 but only 357 questionnaires were returned when the data collection process was concluded. The study had a returned rate of 96.49% (n=357) and the questionnaires were considered adequate for analysis.

A reliability analysis was conducted to measure the internal consistency between the scale items that were used in the questionnaire. A Cronbach's alpha (α) in SPSS's reliability analysis was used in determining whether the scale items were accurate and relevant. The reliability statistics calculated Cronbach's Alpha values of 0.876 for working capital management practices. The acceptable levels for items can be minimally accepted as sufficiently consistent with its demonstrated proximity to 0.7 (Taber, 2018). Thus, the questionnaire was confirmed to be reliable because all the items for the four variables had Cronbach alpha levels greater than 0.7.

Demographic Characteristics

An analysis of participants' demographic characteristics including gender, age bracket, highest education level, job title, and duration of time employed at the firm were analyzed to validate representativeness and reproducibility. The results were presented in Table 4.

Table 4: Sociodemographic Characteristics

Variable	Characteristic	Frequency (n)	Percent (%)
Gender	Female	58	16.2
	Male	299	83.8
Age Bracket	20 years and below	0	0
	21-30 years old	18	5.0
	31-40 years old	96	26.9
	41-50 years old	176	49.3
	51 years and over	67	18.8
Highest level of education	Secondary	2	6

	Diploma	15	4.2
	Degree	126	35.3
	Masters	185	51.8
	PhD	29	8.1
Job title	SME Owner	249	69.7
	Manager/Supervisor	108	30.3
Duration of time employed in the profession	Less than 1 year	6	1.7
	1-2 years	24	6.7
	2-3 years	124	34.7
	Over 3 years	203	56.9
Total		357	100

The results in Table 4 demonstrate that there were a majority of male participants 83.8%, n=299) compared to the female participants (16.2%, n=58). Most of the participants were between 41 and 50 years (49.3%, n=176) while those with 51 years and above represented 18.8% (n=67) of the population. Averagely, majority of the participants were in the age bracket of 31 to 50 years. On the other hand, most of the participants had a postgraduate degree with those with Masters education representing 51.8% (n=185) of the study population while the participants with PhD represented 8.1% (n=29) of the study population.

All the study participants had at least a diploma qualification. The study intended to involve 70% (n=259) SME owners while the actual study managed to collect data from 69.7% (n=249) SME owners. The remaining SME owners did not return their questionnaires as expected when the data collection exercise concluded. 56.9% (n=203) had spent more than 3 years with the SME firm while 34.7% (n=124) of the participants indicated to have worked with the associated firm for 2 to 3 years.

Descriptive Analysis for Cashflow Management Practices

The researcher analysed responses concerning participant agreement on the extent working capital choices affected financial performance of SMEs and the results were recorded in Table 4.10. The scale was used include "5= Strongly Disagree, 4= Disagree, 3=Neutral, 2=Agree, and 1=Strongly Agree". The analyzed results are presented in Table 5.

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Table 5: Descriptive statistics for level of agreement on the impact working capital choices have on SME's financial performance

Statements on working capital management	Mean	Standard Dev.
The firm has a working capital management system	2.26	0.822
Firm regularly update and maintains inventory records	2.20	0.892
There is a full automation of the accounts receivable management system	2.36	0.946
The firm maintains optimal cash balances	2.18	0.785
Ensures sufficient cash flow to meet daily needs	2.31	0.893
Maintains proper records for all payables	2.36	0.949
Prepares cash flow forecasts to identify future cash needs	2.34	0.861
Aggregate mean	2.287	0.8783

The participants agreed that working capital choices affected the financial performance of SMEs as indicated by an aggregated mean value of 2.287 and a mean standard deviation of 0.8783. An aggregate standard deviation of 0.8783 indicates consistency in response values which were tightly clustered around the means. The findings exhibit consistency with past studies, such as Nurein and Din (2017), Oluoch (2016), and Alvarez et al. (2021) that established a significant positive relationship between working capital management practices and financial performance of firms.

Correlation Analysis

Correlation analysis revealed that working capital management practices have a strong and positive association with the financial performance of SMEs in Nairobi City County, Kenya.

Table 6: Correlation analysis

	Pearson's Correlation coefficient	Sig.	Comment
Working capital management practices	0.76	0.00	Strong and positive

Person's correlation coefficient was 0.76 and it was found to be statistically significant at 0.01 level (p=0.00).

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Regression Analysis

The regression analysis results showed that R-squared value was 0.372 (R^2=0.372). Results establish that only 37.2% (R-Squared=0.372) of the variability observed in financial performance is explained by regression model 1. Thus, the financial management practices included in this model are responsible for 37.2% variability in performance; the rest of the variability (62.7%) is caused by factors not in this model. The standard error of the estimate was 0.449.

The coefficient of working capital management was 0.160 with a constant of 0.733 as detailed in Table 7.

Table 7: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	.733	.106		6.896	.000
	Working capital decision	.160	.061	.162	2.641	.009

a. Dependent Variable: Financial performance (ROA)

The results in Table 7 depict that there is a significant and positive relationship between working capital management practices (coeff=0.160, sig=0.009) and SME firms' financial performance. The constant value implies that at zero level of working capital management practices, SMEs' financial performance is 0.733. Using the results, a regression model can be developed as:

Y=0.733 + 0.160X + 0.449……...…(ii)

Y is the dependent variable (financial performance) and X is the independent variable (working capital management practices).

The findings of this study established the existence of a positive statistically significant effect of working capital choices on service SME firms' financial performance. Notably, the findings were consistent with studies conducted by Anangwe and Malenya (2020), Nurein and Din (2017), and Oluoch (2016) that successful cash management techniques and overall choice of working capital had significant impacts on SME's financial performance. The number of inventory days and cash conversion cycle have a positive correlation with increased shared value as SME firms improve efficiency through reduced time required for obtaining accounts and paying for inventories. Therefore, Nairobi County's SME firm working capital management practices can guarantee improved efficiency through early inventory and bill payment as suggested by Oluoch (2016). Nairobi County SMEs have tried to integrate efficient inventory management practices and computer-assisted software for stock management which have significantly enhanced their financial performance.

5. Conclusions

Working capital choices have a positive and significant impact on service SMEs' financial performance. Making correct working capital increases the likelihood of firms generating high profits from SME operations. SMEs in Nairobi City County that make working capital choices achieve tremendous results in financial performance. Lack of availability of funding is one of the issues that the vast majority of small and medium-sized businesses in the service industry encounter. Therefore, ensuring that working capital is managed effectively increases the available funds and ensures SMEs exhibit satisfactory financial indicators.

6. Recommendations

The study indicated that adopting effective working capital management practices will increase an SME firm's internal resourcefulness with a further application of the affordability logic that can help the firm overcome funding challenges while achieving high financial performance and sustainable growth. The study also recommends SME firms to develop suitable policies and strategies linked to working capital management practices for enhanced financial performance.

7. Suggestions for Future Research

Researchers in future studies can evaluate secondary empirical evidence from more recent literature to enhance relevance and accuracy of studies regarding the dynamic nature of SMEs in the country and the financial management practices that are being practiced. The research successfully recruited 370 SME owners and managers but the response rate fell short of 100%. Future research questionnaires can aim to limit insignificant questions which is a strategy for being considerate of the respondents' time and minimizing respondent fatigue.

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