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Relationship between the Cost of Preference Shares and Financial Performance of Selected Firms in NSE, Kenya

Dr. Makori Onkware
Student, Department of Accounting and Finance, Kisii University, Kenya

Abstract:
Firms listed in NSE have not been able to appropriately choose the right mix of the cost of capital. This has negatively affected their financial performance, and hence there is a need to ascertain the relationship between cost of preference shares and the financial performance of manufacturing firms listed in NSE. The study was informed by the pecking order theory. The study adopted a descriptive research design. The unit of observation was companies Listed in NSE (NSE). According to NSE, there are 64 listed companies. The study purposively selected manufacturing firms that are listed at NSE. According to NSE, there are 8 manufacturing firms that are listed at NSE. The researcher collected secondary data from the audited annual financial reports of 8 manufacturing firms listed in NSE. The study used a data collection sheet to assist in data collection. Descriptive and inferential analysis was used in data analysis. The study findings revealed that cost of preference had no significant relationship with financial performance. The study concluded that only Orchard manufacturing company had mean preference shares for the 2012 to 2018 period, with other manufacturing firms recording zero preference shares for the same period. According to the findings of the study, preference shares have a little impact on the financial performance of manufacturing companies listed on the NSE. As a result, it was recommended that companies should avoid raising capital through preference shares because they had a marginally negative impact on their financial performance.

Keywords: Cost of preferences shares, financial performance, Nairobi securities exchange

1. Introduction

Cost of preference shares plays a distinctive role in predicting future cash flows by the investing community, and the biggest reason for the attention to earnings lies in the notion that preference costs serve as a predictor of future cash flows. Preference share capital in India is a function of the dividend expected by investors. Preference capital is never issued with the intention not to pay dividends. Although it is not legally binding upon the firm to pay dividends on preference capital, it is generally paid when the firm makes sufficient profits. Although the failure to pay dividends does not cause bankruptcy, it can be a serious matter from the ordinary shareholders' point of view. The non-payment of dividends on preference capital may result in voting rights and control to the preference shareholders. More than this, the firm's credit standing may be damaged (Joshi, 2012).

In India, the preference share capital is a function of the dividend expected by investors. Preference capital is never issued with the intention not to pay dividends. Although it is not legally binding upon the firm to pay dividends on preference capital, it is generally paid when the firm makes sufficient profits (Joshi, 2012). According to Raubenheimer (2013), although the failure to pay dividends does not cause bankruptcy, it can be a serious matter from the ordinary shareholders' point of view. The non-payment of dividends on preference capital may result in voting rights and control to the preference shareholders. More than this, the firm's credit standing may be damaged (Joshi, 2012).

According to Busetti (2017), redeemable preference shares (that is, preference shares with finite maturity) are also issued in practice as the cost preference capital in manufacturing companies in Ghana. The cost of preference share is not adjusted for taxes because preference dividend is paid after the corporate taxes have been paid. Preference dividends do not save any taxes. Thus, the cost of preference capital is automatically computed on an after-tax basis. Since interest is tax deductible and preference dividend is not, the after-tax cost of preference capital is substantially higher than the after-tax cost of debt.

Gitau (2012) reports that due to the developing nature of the Kenyan economy and the rapid population growth rate, firms are able to identify growth opportunities with relative ease. These opportunities require investment in capital expenditure in order for them to be realized. The cost of preference share capital is apparently the dividend that is committed and paid by the company. This cost is not relevant for project evaluation because this is not the cost at which further capital can be obtained. The preference share is issued at a stated rate of dividend on the face value of the share (Kamau, 2015).

Gitau (2012) further reports that although the dividend is not mandatory and it does not create legal obligations like debt, it has the preference for payment over equity for dividend payment and distribution of assets at the time of liquidation. Therefore, without paying the dividend to preference shares, they cannot pay anything to equity shares. In that scenario, management normally tries to pay a regular dividend to the preference shareholders.

Siro (2013) states that financial performance measures, for instance, profitability and liquidity, provide stakeholders with a valuable tool to evaluate both the historical and current financial position of a firm. Antwi, Fiifi & Atta (2012) noted that business enterprises that record higher profits tend to prefer the use of higher levels of debt. Tailab (2014) noted that the correlation between capital structure and performance in terms of profitability in American energy firms between 2005 and 2013 was negative. Similar findings applied to the studies on firms from 14 European countries (Mathur, 2015).

Usman and Azeem (2014), in their study of sugar firms listed in the Karachi securities exchange between 2006 and 2011, established that there is a weak positive correlation between capital structure and financial leverage. Pouraghajan (2012) conveyed a negative relationship between leverage and the financial performance of firms on 12 industrial firms listed on the Tehran Stock Exchange. Salim and Yadav (2012) also found a negative relationship between capital structure and the performance of Malaysian firms for the research conducted on 237 listed firms from 1995- 2011. Al-Taani (2013) studied the relationship between capital structure and financial leverage on 45 manufacturing companies listed on the Amman Stock Exchange in Jordan, covering five years from 2005-2009. The research established a positive correlation between the two parameters.

1.1. Statement of the Problem

Financial performance measures, profitability, and liquidity additionally give partners a significant device to assess both the recorded and current financial position of a firm. To a large extent, a company's financial performance relies on the financing approach it decides to depend on. The firm may entirely depend on debt, equity, and cost of capital and preference shares or use more than two of them. The ability of an organization to optimize the mode of financing and its size ascertains its financial performance. When an organization can optimize the financing mode, it positively affects its financial performance. The majority of listed firms have experienced losses in their financial performance over the years; for instance, in 2016, ARM recorded a loss of Ksh 6.3 billion, while in 2017, the company recorded a loss of ksh 6.9 billion (Kenya Association of Manufacturers Priority Report, 2018). In response to the poor financial losses by some selected firms listed in NSE and the fact that some of them are among the four economic pillars in the Big four Agenda of the government of Kenya and vision 2030. Thus this research sought to ascertain how the cost of capital components and the financial performance of selected firms in NSE relate.

Studies have been undertaken on the role of manufacturing firms' financial performance and firm size; for instance, Njenga (2014) conducted a study to assess the relationship between the cost of capital and financial performance and the position of manufacturing companies listed on the Nairobi Securities Exchange. The study used a descriptive research design. The research model used was the debt-equity ratio as the independent variable, whereas the dependent variable was the return on equity and profitability ratios. The study revealed that there is no significant statistical relationship between capital structure and financial profitability of the manufacturing firms listed on the Nairobi Securities Exchange. However, Njenga's study concentrated on the debt-equity ratio and return on equity to measure the profitability of the firms, excluding other indicators such as the cost of preference shares which also influences the financial performance of the firms. Therefore, there is a need to study the relationship between the cost of preference shares and the financial performance of selected firms in NSE, Kenya.

1.2. Research Hypothesis

Cost of preference shares has no statistically significant relationship with the financial performance of manufacturing firms listed in NSE, Kenya.

2. Literature Review

2.1. Theoretical Review

The study is informed by the Pecking Order Theory. Pecking Order Theory was proposed by Myers and Majluf (1984). The pecking order theory emphasizes that business enterprises rank internal sources of finance first, then external sources of finance comprising low-risk debt financing and share financing (Afrasiabishani, Ahmadinia, and Hesami, 2012). The pecking order theory states that a firm will finance its needs in a hierarchical manner by the use of internal funds, leverage, and external equity in that order.

This theory implies a negative correlation between the profitability of firms and external borrowing; that is, a firm that generates enough profits has a reduced need to borrow because it can finance its operations with the profits gained (Saad, 2015). However, Pecking Order theory does not consider optimal capital structure (or there is no target capital structure) (Luigi & Sorin, 2009; Mostafa & Boregowda, 2014). Besides considering information asymmetry, this theory also considers the signaling effect (Schoubben & Hulle, 2004).

Understanding the sources of valuable resources would help managers to exploit opportunities and extend their competitive advantage for a longer period of time. The positive relationship between short-term debt and the profitability of a firm is consistent with the trade-off theory, where short-term debt being a cheaper source of financing, contributes significantly to the profitability of the firm (Saad, 2015). On the other hand, the negative relationship between long-term debt and profitability is consistent with the pecking order theory, where profitable firms prefer to use earnings for their financing needs rather than debt (Barney & Clark, 2007). Thus, the theory is applicable to the study as it will help to explain the effect of the cost of preference capital on the financial performance of the manufacturing firms listed in the Nairobi Security Exchange.

Pecking order theory is relevant to this study as it argues that firms first choose to employ internal sources like reserves & retain earnings to finance a project instead of arranging new debt or preferring debt to the issuance of new shares. Managers will not issue new undervalued shares if they are acting in favor of shareholders. Managers will issue new equity shares with the hope of getting offset by NPV of growth opportunity or new investment opportunity. This leads to a drop in share price. Hence, this is a bad news for assets in place. The issue becomes worse as the information asymmetry increases. For investing, firms with more growth opportunities are better than matured firms because the price falling down is affected by growth opportunity value versus assets in place.

2.2. Cost of Preference Capital on Firms' Financial Performance

Okiro, Aduda & Omoro (2015), in a study on the effect of cost of preferences on firm performance, found that there was a positive significant relationship between the cost of preferences and firm performance as CS and regulatory compliance and performance of firms listed on the East African Community Securities Exchange. The study was conducted on 56 firms listed on exchanges of countries belonging to the East African Community. The hypothesis tested was that there was no significant relationship between CS and firm performance among listed companies at the EAC securities exchange. Regression was used to test the hypothesis. The findings of the study did not confirm the hypothesis.

Mukembo (2018) conducted a study on preference shares and the financial performance of manufacturing SMEs firms in Uganda. The study applied a cross-sectional design which was quantitative and descriptive in nature. Empirical data on capital performance and financial performance of the selected SMEs were analyzed using STATA and MS Excel to establish the actual relationship between the key variables selected for the study. Results revealed a significant negative relationship between preference cost and the financial performance of manufacturing SMEs. Findings further showed that SMEs were highly leveraged with a short-term debt ratio to total assets signifying that manufacturing SMEs rely on customer deposits, term deposits, and short-term loans to finance their operations.

Boyani (2015) conducted a study on the effect of the cost of preferences of firms manufacturing firms listed on the Nairobi securities exchange. The study reviewed literature on capital structure and determinants of a firm's cost of capital. The size of the firm was found to be a determinant of the cost of capital and was measured as the value of total assets held by a firm. The cost of preferences was measured as the leverage ratio of total debt over total equity, while the cost of capital was measured as the weighted average cost of capital. The relationship between capital structure and the cost of preferences was explained using regression analysis. The study found that a positive relationship existed between capital structure, the cost of capital, and the size of the firm, such that an increase in capital structure and size of the firm resulted in an increase in the cost of capital at statistically significant levels. The study concluded that an increase in the leverage ratio will lead to an increase in the cost of capital, while a decrease in leverage will correspond to a decrease in the cost of capital of firms listed on the NSE.

Kanini (2014) investigated the relationship between the cost of preferences and investment decisions listed in the Nairobi securities exchange. The study explored the interdependence of the cost of capital and investment decisions by documenting the relationship between corporate leverage and investment choices. By using the data of manufacturing companies listed in Nairobi Securities Exchange for five years (2008-2012) as the sample, the obtained data was filtered to obtain the relevant statistics that could be analyzed through SPSS. The analysis was done by applying multivariate regression analysis and t-test. The study found that there was a significant likelihood of a firm elevating-leverage to increase the company value. The result revealed that investment decisions had positively influenced the company value, which meant the investors assumed the management had performed well in searching and investing the obtained capital from debt.

Otieno (2015) investigated the cost of preference capital of listed firms in Kenya: the case of manufacturing firms. This study investigates the effects of preferences capital of listed firms in Kenya with the intention of identifying the factors that determine their choice. The study was conducted based on a sample of 29 manufacturing firms listed on the Nairobi Securities Exchange from 2004 to 2012 using the panel data estimation technique. Both the fixed effects and random effects models are estimated. The results reveal that firm-specific factors affecting the capital structure of listed firms in Kenya are asset tangibility, firm's profitability, size of the firm, firm's growth opportunities, and finally, liquidity of a firm's assets, while the macroeconomic factors are economic growth and corporate tax rate.

Mwaniki (2016) conducted a study on the effect of preference capital on the financial performance of manufacturing firms listed at the Nairobi security exchange. The study adopted a descriptive research design. The target population for the study consisted of 47 manufacturing firms listed at NSE. The collected data was analyzed using SPSS software. The study found out that:

- 17.5% change in capital structure among non-financial firms listed on the NSE is explained by the four independent variables of the study (Financial Leverage, Solvency, Size, and Growth Rate),
- Moderate negative correlation exists between the financial leverage of manufacturing firms listed at NSE and financial performance,
- A strong positive relationship exists between solvency and financial performance, and
- A strong positive correlation exists between the size of the manufacturing firm and financial performance

The study concludes that preference capital affects the financial performance of the non-financial firms listed at NSE.
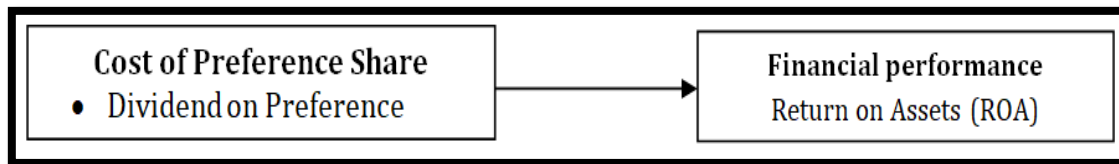
2.3. Conceptual Framework

Figure 1: Conceptual Framework

3. Research Methodology

The study adopted the positivism approach, which advocates for the application of methods of natural sciences to the study of social reality and beyond. The study adopted a descriptive research design. Descriptive research is a social research design that primarily aims to describe (rather than explain) a particular phenomenon (Bless & Higson-Smith, 2013). The research was carried out in Kenya, specifically in the eight manufacturing organizations listed on the Nairobi Securities Exchange. The targeted listed firms are located in the Nairobi Metropolitan Area. According to NSE, there are 64 listed companies that are categorized into 13 groups. The study purposively selected manufacturing firms that are listed at NSE. According to NSE, there are 8 manufacturing firms that are listed. Purposive sampling is a form of non-probability sampling in which researchers rely on their own judgment when choosing members of the population to participate in the study.

Manufacturing
B.O.C Kenya Ltd Ord 5.00
British American Tobacco Kenya Ltd Ord 10.00
Carbacid Investments Ltd Ord 5.00
East African Breweries Ltd Ord 2.00
Unga Group Ltd Ord 5.00
Eveready East Africa Ltd Ord.1.00
Kenya Orchards Ltd Ord 5.00
Flame Tree Group Holdings Ltd Ord 0.825

Table 1: Sampling Frame
Source: Kenya Association of Manufacturers Priority Report, 2019

The study gathered secondary data on the cost of preference shares and the financial performance of manufacturing firms Listed on Nairobi Securities Exchange. The study used both descriptive and inferential analysis. Descriptive statistics involved the use of absolute and relative (percentages) frequencies, measures of central tendency, and dispersion (mean and standard deviation, respectively). Frequency tables were used to present the data for easy comparison. Correlation regression analysis was used in the study to identify the relationship between the cost of preference shares and the financial performance of manufacturing firms listed in Nairobi Security Exchange, Kenya. Data analysis was done with the aid of SPSS Version 25 was used. All inferential statistics were tested at $p < 0.05$ significance level. The study was presented in the form of tables and graphs.

$Y = \beta_0 + \beta_1 X_1 + \varepsilon$ ……………………………………….. i

Where:
- Y = Financial Performance
- β_0 = Constant Term
- X_1 = Cost of Preference Shares
- ε = Error Term
- β_1 = Regression Coefficients

4. Findings of the Study

4.1. Response Rate

The 8 manufacturing firms examined by the study included:
- Flame Tree group,
- Unga Ltd,
- Kenya Orchards,
- BAT Kenya,
- EABL,
- Carbacid Investments,
- Eveready, and
- BOC Kenya

4.2. Mean Cost of Preference Share of Each of the 8 Manufacturing Companies Listed in NSE for the 7 Years
　　　　The study sought to ascertain the mean cost of preference share of each of the 8 manufacturing companies listed in NSE for the 7 years. The findings are indicated in table 2.

	N	Minimum	Maximum	Mean	Std. Deviation
Flame Tree	7	0	0	0	0
Unga Ltd	7	0	0	0	0
Orchard	7	55,000.00	55,000.00	55,000.00	0
BAT	7	0	0	0	0
EABL	7	0	0	0	0
Carbacid	7	0	0	0	0
Eveready	7	0	0	0	0
BOC Kenya	7	0	0	0	0
Average				6,111.11	

Table 2: Preference Shares
Source: Field Data, 2020

　　　　The study results discovered that only Orchard manufacturing company had mean preference shares for the 2012 to 2018 period, with other manufacturing firms recording zero preference shares for the same period.

Descriptive Statistics						
	Minimum	Maximum	Mean	Std.	Skewness	Kurtosis
Cost of Preference shares	0	6,111.11	6,111.11	0.0011	.567	1.032

Table 3: Cost of Preference Shares from 2012-2018

　　　　The study further sought to ascertain the trend of the cost of preference share of each of the overall 8 manufacturing companies listed in NSE for the 7 years. The findings are indicated in figure 2
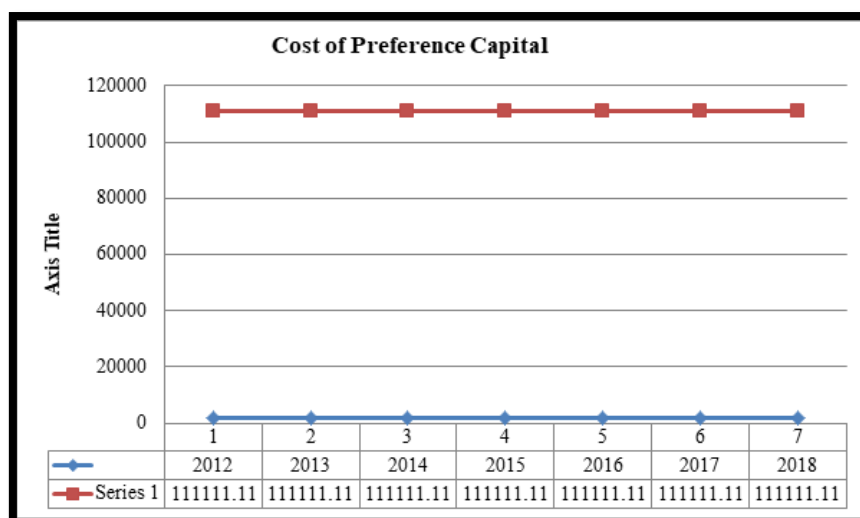

Figure 2: Cost of Preference Shares from 2012-2018

　　　　The finding showed that the mean for the price of preference shares of the 8 listed manufacturing firms companies listed in NSE was 15873.01587. The minimum value for the price of preference shares was 0, while the maximum quantity for the cost of preference shares was 6,111.11. The finding also revealed that the cost of preference shares has a standard deviation of 0.0011, which means that the variable has a relatively smaller deviation. In addition, the datasets for the cost of preference shares were moderately skewed, given that the skewness value was 0.567. Furthermore, the results discovered that the cost of preference shares had a kurtosis of 1.032. The findings also revealed that the cost of preferences among the 8 listed companies was constant from 2012 to 2018.

4.3. Return on Assets from 2012-2018
　　　　The study sought to determine ROA mean of each of the 8 manufacturing firms listed in NSE for the 7 years. The findings are indicated in table 4.

	N	Minimum	Maximum	Mean	Std
Flame Tree	7	.00	0.17	0.09	0.07
Unga Ltd	7	.00	0.07	0.05	0.02
Orchard	7	.00	0.67	0.18	0.25
BAT	7	.00	0.41	0.32	0.08
EABL	7	.00	0.33	0.21	0.07
Carbacid	7	.00	0.22	0.15	0.04
Eveready	7	.00	0.49	0.09	0.31
BOC Kenya	7	.00	0.10	0.05	0.03
Average Mean				0.14	

Table 4: Return on Assets

The findings revealed that BAT had the highest (Mean= 0.32; SD= 0.08), followed by EABL (Mean= 0.21; SD= 0.07), Orchards (Mean= 0.18; SD= 0.25), Carbacid (Mean=0.15; SD= 0.04), Flame Tree (Mean=0.09; SD= 0.07), while Eveready indicated a (Mean=0.09; SD= 0.31), BOC Kenya had (Mean=0.05; SD=0.03), UNGA LIMITED (Mean= 0.05; SD= 0.02). The findings further revealed that Mumias Sugar recorded a negative return on assets (Mean= - 0.228; SD= 0.35). With an average mean score of 10.6, the study findings indicated that BAT, EABL, ORCHARD, and CARBACID performed better financially between 2012 and 2018, with Flame Tree and BOC KENYA recording good returns. The findings agree with Bayaraa (2017), which showed that growth in sales, earnings per share, and costs to revenue ratio positively influence the financial performance of an organization by ROA.

The study further sought to determine the trend of ROA of all the 8 manufacturing firms listed in NSE for the 7 years. The findings are indicated in figure 3.
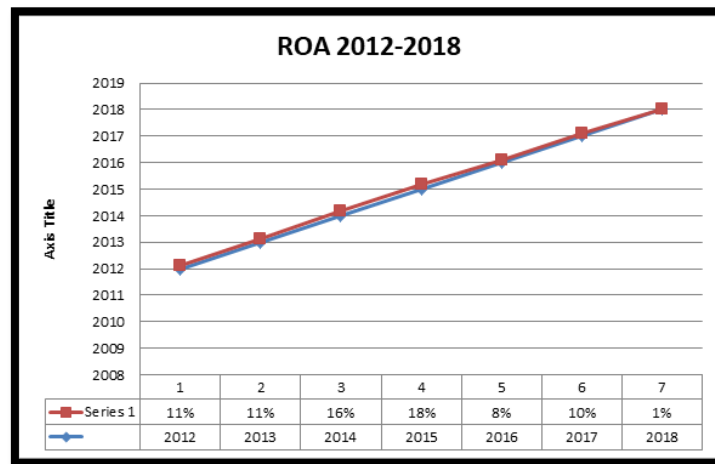

Figure 3: ROA From 2012-2018

The findings revealed that in 2015 the 8 listed manufacturing companies had the highest level of ROA with a mean of 0.17533156, while in 2018, the 8 companies had the lowest level of ROA with a mean of 0.00866789.

4.4. Diagnostic Tests

Normality q-q plot is used to determine how well a variable fits a specific distribution. In a normal distribution, the points in the Q-Q-normal plot-cluster are around the horizontal line.
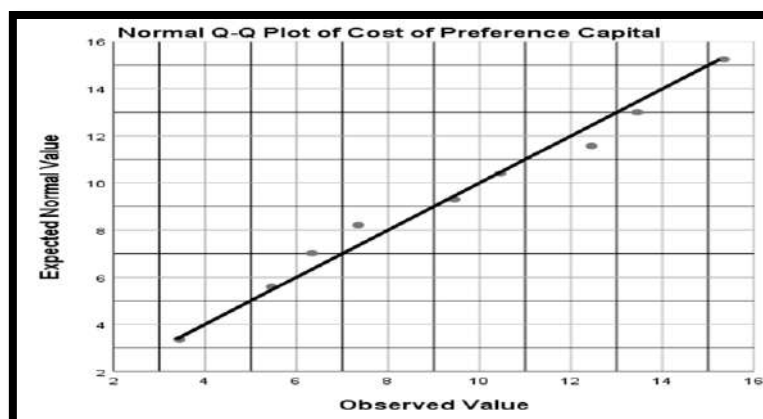

Figure 4: Normal Q-Q Plot of Cost of Preference Shares

The findings reveal that the points in the Q-Q-normal plot cluster around the horizontal line. The cost of preference shares deviating from the straight line is minimal. This indicates normal distribution.
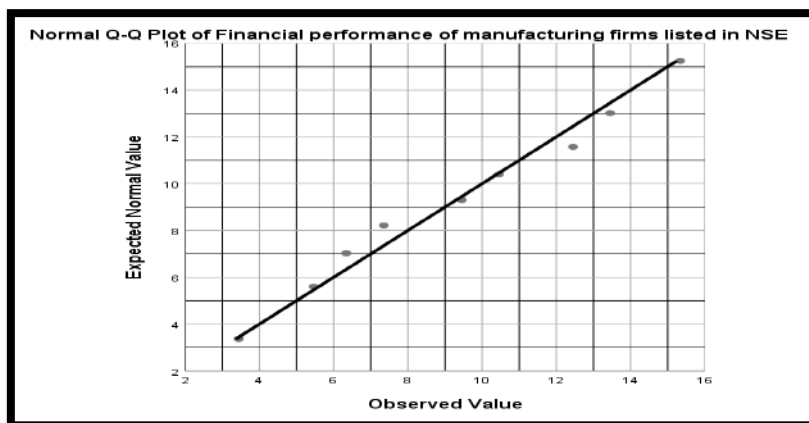

Figure 5: Normal Q-Q Plot of Financial Performance

The findings show that the Q-Q-normal plot points cluster around the horizontal line. The financial performance observation is a long straight line. This indicates normal distribution.

4.5. Correlation Analysis

The researcher conducted a correlation analysis to determine the existence and intensity of the relationship between the cost of preference share and the financial performance of manufacturing firms listed in NSE. The Pearson correlation coefficient measures the strength of a linear association between two variables and takes a range of values from +1 to -1.

ROA		
Cost of Retained Earning	Pearson Correlation	. 181
	Sig. (2-tailed)	. 018
	N	56

Table 5: Correlation Analysis of the Relationship between Cost of Preference Shares and
Financial Performance of Manufacturing Firms
*. Correlation Is Significant at the 0.05 Level (2-Tailed)

The results illustrated that r=0.181. The p-value was higher than the 0.05 level of significance, meaning that there is a positive statistically insignificant relationship between preference shares and the financial performance of manufacturing companies listed in NSE. This finding is consistent with Mukembo (2018), who claimed that preference shares and financial performance of SMEs related significantly, implying that SMEs were heavily reliant on short-term debt to supplement resources, implying that manufacturing SMEs rely on client stores, term stores, and transient advances to finance their operations.

4.6. Model Summary on the Cost of Preference Shares

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.084ᵃ	.007	-.011	.16591863
a. Predictors: (Constant), Cost of Preference Share				

Table 6: Model Summary of Cost of Preference Shares

The results show that cost of preference shares contributed 0.7% to the financial performance of the manufacturing firms listed in the NSE, while 99.3% is the variation due to other factors.

4.7. ANOVA of the Cost of Preference Shares

ANOVA was deployed to ascertain the fitness of the model in predicting the relationship between the cost of preference shares and the financial performance among manufacturing firms listed in NSE.

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.011	1	.011	.383	.538b
	Residual	1.487	54	.028		
	Total	1.497	55			
a. Dependent Variable: Financial Performance						

Table 7: ANOVA of the Cost of Preference

The findings show the F Value of 0.383; hence it was concluded that the model was suitable for predicting the relationship between the cost of preference shares and financial performance.

4.8. Regression Coefficient of the Cost of Preference Shares

	Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.140	.024		5.896	.000
	Cost of Preference	7.547	.000	.084	.619	.038
a. Dependent Variable: Financial Performance						

Table 8: Regression Coefficient of the Cost of Preference Shares

The findings show that a unit change in the cost of preference shares a 7.547 times difference in the financial performance of manufacturing firms listed on the NSE. Based on the finding, the following regression model is shown below:

$$Y = .140 + 7.7547 \ X_4 + \varepsilon$$

The findings revealed that the cost of preference shares has a statistically significant effect on the financial performance of manufacturing firms listed in NSE. As a result, the null hypothesis was rejected, and it was ascertained that the cost of preference has a substantial impact on the financial performance of manufacturing firms listed on the NSE.

5. Conclusions and Recommendations

From the findings, the study concluded that cost of preference had a significant relationship with the financial performance of manufacturing firms listed in NSE. In addition, the study concluded that only Orchard manufacturing company had mean preference shares for the 2012 to 2018 period, with other manufacturing firms recording zero preference shares for the same period. According to the findings of the study, preference shares have a little impact on the financial performance of industrial companies listed on the NSE. As a result, it was recommended that companies avoid raising capital through preference shares because they had a marginally negative impact on returns.

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