# The impact of liquidity on the financial performance of microfinance institutions: Evidence from Mombasa town, Kenya

# ABSTRACT

*Microfinance institutions have encountered by difficulty determining the prime point or the level at which they can uphold its liquidity so that to augment its profitability. The difficulty becomes further distinct as good records of institutions particularly microfinance institutions are engaged with profit maximization hence they incline to disregard the significance of liquidity management. Near this end, the study tried to found the effect of liquidity on the financial performance of microfinance institutions in Mombasa town, Kenya. The study embraced descriptive research design. A regression model was used to determine the relationship between the financial performance and independent variables which included debtors, creditors and cash flow. The outcome shown that the correlation between liquidity and financial performance is strong with an A R2 of 54%. The research summarissed that liquidity management is a major contributor of the microfinance financial performance. However, it is significant for a firm to understand the effect of liquidity mechanisms on the microfinances financial performance and also commence deliberate measures to augment its liquidity level. In addition the research recommendend a further study on the role of liquidity on a microfinance financial performance by incorporating more liquidity variables.*

*Keywords: Microfinance, financial performance, liquidity components, stock market*

***Introduction***

“Liquidity management of the microfinance is negatively associated to the financial performance of financial organizations that was evidenced during the worldwide COVID-19 that hit the economy including microfinance institutions” (Ware, E. O. 2015). “The study also found out that COVID implication was too huge on the stock market as shares lose prices affecting many economies facing huge financial blows resulting to foreclosures, auctioning of houses and unembellished redundancy”. (Mwambui and Koori,2019)

According to Choo, P. S. (2018) when a micro finance has destitute liquidity management, it possesses the main cash flow limit which undesirably affects their cost-effectiveness. Therefore, “if liquidity management is not managed orderly it may lead to poor liquidity costs in microfinance institutions. Henceforth, microfinance face the dilemma on how to classify the level which it can maintain its assets in order to exploit productivity needs of investors since every liquidity has a varied impact on the growth level. The happenstance is there when microfinance tend to quintessence on profit intensification ignoring cash flow management however liquidity can lead to bankruptcy” (Talaso, P. L. 2018).

“The COVID19 conveyed financial crisis in microfinance since 2020 highlighted the role of cash flow management to microfinance institutions in that very liquid assets have low risk they impose holding opportunity cost to microfinance and low returns thus microfinance managers should trade off risk and return on cash flow” (Sheikhdon, A. A., & Kavale, S. 2016). “In circumstances where there is no guidelines, microfinance are anticipated to hold liquid assets to that extend that they help to exploiting the microfinances financial presentation. Business organizations thus have a choice to require holding of liquid assets in huge amounts to progress the steadiness of overall financial structures” (Musembi, D. M. 2018)

**Statement of the Problem**

Liquidity management is noteworthy as it appraisals the ability of a firm to be able to change its assets to cash easily making the business to have all set cash flow to enable its operations . Microfinance institutions persist the minimum statutory liquidity desires of 20% by having a overall liquidity ratio of 38.30% as at the end of 2019 notwithstanding the fact that some microfinance institutions had a pretax profit of 28.482 million as the best actor and while others has a loss of 2.889 million as the poorest performance.

Therefore, the research examined the effect of liquidity and financial performance of microfinance establishments in Mombasa town, Kenya, as validated from CBK (Bank supervision Annual Report 2021 -2024) where there is a deterioration of the proportion of profitability from 3% in 2021 and 202022 to 2% in 2023 and 1% in 202024 which portrays that the microfinances institutions are not efficient in utilizing their resources. Henceforth, the current study envisioned to establish why there is a deteriorating performance of microfinance institutions.

“At the end of the financial year 2021, out of 13 microfinance institutions, 5 made profits after tax and 8 made losses which are more than a half. Microfinance institutions offer credit facilities to its customers from deposits made by clienteles and most financial operations are carried out through the deposits thus in situations where majority of depositors make massive withdrawals the bank will face liquidity management trap that may lead to borrowing among microfinance institutions which has higher costs. Due to these problems microfinance institutions tend to uphold more cash that incur high holding costs in maintaining statutory investments not less than statutory minimum” (Musyoka, B. K. 2017). Additional investigation has been done in respect to cash flow management on financial performance in microfinance institutions. Mucheru, E., & Shukla, J. (2017) deliberate on “result of liquidity on the financial performance of Kenyan microfinance organizations. The study adopted a sample design limitations as secondary data of only 38 microfinance institutions was available and the quality of results depends upon the available data. The present study used primary data to offer comprehensive description on the independent variables and secondary data on dependent variable of microfinance institutions”. Bwoma, G. N., Muturi, W. M., & Mogwambo, V. A. (2017) investigated the “outcome of liquidity management on financial performance among Kenyan microfinance institutions in Kenya. The study utilized cross sectional design which is free of bias and the study suffered from sample design limitations as it was undertaken on microfinance institutions within five finest execution counties. In addition, guideline of microfinance institutions is dissimilar from guideline of the commercial banks. No study has been done comprehensively in respect to microfinance institutions pertaining to cash flow management on deteriorating financial performance in Kenya despite their constant high liquidity ratio more than the minimum statutory requirement of twenty percent as Kenya Women Microfinance Bank had a liquidity ratio of twenty eight percent with a net profit after tax of 224 million whereas Rafiki Microfinance institutions had a liquidity ratio of twelve percent with a net loss of 298 million which highlights that microfinance institutions have a problem with liquidity management”.

**General objectives of the Study**

The leading objective of this research was to find out how liquidity influences the financial performance of microfinance institutions.

**Specific objectives**

1. To find out the effects of trade receivables on financial performance of microfinance institutions.
2. To find out the effects of trade payables on financial performance of microfinance institutions.
3. To find out the effects cash flow on financial performance of microfinance institutions.

**Research Hypotheses**

1. H01: There is no effect of trade receivables on the financial performance of microfinance institutions?
2. H02: There is no effect of the trade payables on the financial performance of microfinance institutions?
3. H03: There is no influence of cash flow on the financial performance of microfinance institutions?

## Fig 1 : The Conceptual Framework

**Independent Variable Dependent Variable**

* Debtors

Financial Performance - Profitability

* Creditors
* Cash flows

**Theoretical Review**

**Pecking Order Theory**

 Ramamoorti, S., Epstein, B. J., Dorrell, D. D., &Varadarajan, V. (2017) stipulates that pecking order theory can be related with Myers (1994) whom said that “commerce often finance their desires in a systematic way by first manipulating available cash within and then source of external cash and lastly ordinary share capital. The model objective to avoid the risks that may occur when profitable investment developments do not appeals to cash within. The prototypical assumes that when the yields are not adequate, business will rather seek debit rather than finance through owner’s capital as debt providers who already have entitlements on the organization’s yields and assets that may be less risks those equity investors in errors in the firm’s assessment”. Henceforward, in this model, administrators will only opt for owner’s capital as a latest option. Ghafoor, A., Zainudin, R., & Mahdzan, N. S. (2019) insisted that the pecking order theory recognized by Myers (1994) hypothesized that “liquidity applies the opportunity and that administrators will make economic conclusions that are intended to accomplish the worsening in the ineffectiveness in the firm as an outcome less data and information. Myers further stated that in the course of explaining the valuation of business deeds, a firm will face trials of information irregularity in addition to poor performance. Consequently, managers of a firm will consider owners capital of finance to financing externally with preferred borrowing financing than financing through common shares”. According to Koech, P. (2018) Myers (1994) suggested that “some organizations have a model to define the available finance and this grants the anxiety of dilution and interruption of power in a firm and may contribute to a selection of a source”.

**Buffer Theory of Capital Adequacy**

Okumu, A. N. (2019) recorded that the buffer theory of capital adequacy by Sifuna, M. A. (2018) assumes that “an organization attainment for a supervisory least capital ratio can have a reason for enhancing capital and sinking risks so as to avoid regulatory costs brought about by the breach of capital requirements. This theory is grounded on how tantalizing of investment adequacy ratio, fidelity and consistency of strategic planning to pivot against extended undercapitalization and avoid authorizations and possible closure by a monitoring body as a breach of capital requirements is a significant violation of banks’ legislation that may lead to termination of the microfinance institution”. Onsongo, S. K., Muathe, S., & Mwangi, L. (2019) argued that “the capital shield theory states that microfinance that have small capital safeguards often attempt to restructure an adequate capital shield by amassing the capital and institutions with higher levels of capital buffers attempt to retain their capital buffers. When microfinance organizations have extra capital it inclines to absorb uncomplimentary shocks and as a result it reduces the possibility of disappointment. Microfinance institutions will raise their capital at the time they experience increased portfolio risks in order to maintain their capital buffer which will relate to microfinance performance”. Maniagi, G. M. (2018) find out “those microfinance organizations can select to hold a cushion of surplus capital to reduce the likelihood of falling under the capital requirements authorized with an unstable capital adequacy ratio. Without reaching minimum statutory capital requirements by a financial institution is viewed as a main infringement of statutes regulating the banking sector and is not tolerated by the regulator as banks with prolonged undercapitalization are shut down. This theory supports the capital adequacy variable of the study”.

**Literature Review**

“The action of worsening to meet financial obligations is an important issue that should not be avoided. Regularly the act of default on payments can be credited to provisional circumstances, such as the debtor facing a loss of engagement, meeting an unforeseen and transitory increase in payments that deplete their available funds, or persistent extended period of disorder that leads to financial difficulties. Sometimes customers may fail on their obligations due to the occurrence of permanent failure or the sudden demise of an uninsured individual who lacked sufficient financial means to support their family. Momentary descriptions can be effectively addressed by the execution of demanding oversight and the systematic assessment of projects funded by the loan” (AlAli, M. S. 2020).

“Defaulting on recompense is a genuine misdemeanor that should be attentively avoided completely. Avoidance on portions is typically a transitory occurrence that can be credited to copious aspects, such as the loss of employment by clients, a provisional increase in expenditures that leaves them with inadequate funds to make the repayment. Also some individuals may experience default due to the perpetual disappointment. Comprehensive estimating by a credit applicant is vital prior to making a loan repayment. In western countries such as Germany, credit defaults are not solely attributable to the contrivances employed for managing and supervising loan defaults. The company provides credit management advice to its customers, who have diverse loans from various financial institutions. They bring help, working out, and examination to debtors in order to ensure their adherence to the repayment plan. Real controlling of defaults requires a well-designed plan” (Hayes, 2022).

Dahiyat, A. A., Weshah, S. R., & Aldahiyat, M. (2021) examined “liquidity for microfinance institutions in Mozambique found that risk management is a vital process that could ideally be developed during normal times. It requires careful preparation and assurance on part of all investors. It is inspiring to note that it is possible to minimize risks through diligent management of portfolio and cash-flow”.

Chasha, F., Kavele, M., & Guandaru, C. K. (2022), “in their study on creditors management strategies of some microfinance in Malaysia the majority of microfinance and banks losses stem from absolute default due to incapacity of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank’s dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk”.

Githira, C., Muturi, W., & Nasieku, T. (2019), in their scholarship work on account payable management policies of microfinance institutions in Malaysia most of creditors were found to be outright defaulters due their inability to meet obligations in relation to loans. Account payable emanates from a bank’s dealing with individuals, corporate and financial institutions. A bad portfolio may invite liquidity as well as account payable management.

Hacini, I., Abir, B., & Dahou, K. (2021) examined “the relationship between cash flow and returns of listed firms in Nairobi Securities exchange (NSE), Kenya. Using a multiple regression model, the study discovered a positive connection between cash flow and profitability of listed firms in Kenya”. Kariuki, D. W. K., Muturi, W., & Njeru, A. (2021) scrutinized “the association of cash flow measure and firm profitability. The study found that even with having a high cash flow has, a positive bond with profitability exists”.

## Research Design

The study utilized descriptive survey as it pronounced the existence of present state of affairs. Also it ascertained the charts, tables, graphs, means and other statistical data which helped the researcher to decide the tendencies and information about the population (Saunders, M. L., Lewis, P &Thornhill, A.2009).

**Research Philosophy**

Explicit investigator’s tactic to the research guarantees reliable, obligatory results that address their aims. It encompasses what statistics they are going to collect and where from, as well as how it's being self-possessed and scrutinized.

A framework that guides research methodology based on conceptions of reality and the nature of information is known as a research philosophy (Gadzo, S. G., Kportorgbi, H. K., & Gatsi, J. G. 2019)).

**Target population**

The target populace was 38 respondents designated purposively from the Managers as they have material about the study variables from all 38 registered microfinance institutions in Kenya and 38 target respondent entailing managers. The investigator implemented purposive sampling technique to choose 38 respondents as they had complete information on the variables of the study in all the 38 licensed microfinance in Kenya. The researcher engaged the whole sample of all the elements in the population to produce consistent and detailed information Cooper & Schindler, (2007).

## Data Collection Instrument

Primary data composed using a arranged questionnaire from the designated respondents and secondary data from audited financial statements. Questionnaires were used because they are adaptable in terms of funds, phase and have no interviewer’s bias. The validity of the organized questionnaires was proven through coverage of the study area under examination with respect to the knowledgeable advice view that is used to ensure the content and arrangement of the research tool to make decisions on the validity of the content by ascertaining the construct validity that will enable clear definition of the variables to be considered (Yin, R. 2018)).

### Models used to study data analysis

### 3.9.1 Models used to study data analysis

The multiple regression equation will take the form below.

Y =BO+B1X1 +B2X2+B3X3 + Ɛ.

Where;

 Y= Financial performance

BO= coefficient of intercept

 X1 = debtors management

 X2= Creditors management

 X3= cash flow

B1= Sensitivity of Financial performanceto the independent variable

Ɛ= Error term.

**Ethical Considerations**

Recognized approaches were used in gathering of data from respondents. The researcher assured confidentiality and secrecy.

# Limitations of the study

Some respondents were unenthusiastic to answer questions due to sensitivity of the segment and their situation in the company.

**Findings**

The first objective was to find out how account receivables affect financial performance of microfinance institution operating in Mombasa, Kenya. Expressive outcome showed that the average of account receivables is 0.123. Trend line showed that account receivables declined in 2023/2024 but later increase. A borrower entails the assessment of institution’s assets with directing of understanding the risks each asset possesses. Correlation outcomes indicated that coefficient of account receivables and microfinance institution financial performance has a negative and significant association. Model results established that coefficient of account receivables negatively and significantly affect microfinance institution financial performance. Null hypothesis (Ho1) was rejected and conclusion made that debtor significantly impacts microfinance institution performance. The discovery is consistent with Megeid, N. S. A. (2017) who found that financial performance is directly proportional to account receivables management of microfinance banks in Kenya.

Subsequent objective was opined to find out how tradepayables influence microfinance institutions profitability. It was established that average account receivables using total was £500 million. Line graph showed that microfinance in terms of asset growth has been increasing constantly from 2017 to 2024. Correlation output indicated that coefficient of account receivables and microfinance financial performances are positively and significantly associated. Coefficient of account receivables has a positive significant effect on microfinance financial performance in Kenya. Null hypothesis (Ho2) was rejected and conclusion made that account receivables significantly impacts microfinance performance. The verdict is in same with Young, C. & Holsteen, K. (2020) who establishes that financial performance is directly proportional to account receivables management of microfinance banks in Kenya.

The final objective was to determine how cash flow affects microfinance financial performance in Mombasa, Kenya. Normal cash flow is 0.23 during the measurement period. Line graph above shows that cash sustainability declined in 2021/2022, rose in the period 2022/2023 and later declining in the approach to 2024. Coefficient of cash flow has a positive and significant association with microfinance financial performance using profitability. Coefficient of cash flow positively though insignificant influence microfinance financial performance. The null hypothesis (Ho3) was rejected and conclusion made that cash flow does have an impact microfinance performance. The finding is in pact with Awin, E. (2018) who establish that financial performance is directly proportional to cash flow management of microfinance banks in Kenya.

**Conclusion**

The findings specify that liquidity affects financial performance of microfinance institutions in Mombasa town, Kenya. The liaison between profitability and liquidity is positive suggesting that an increase in liquidity will lead to an rise in financial performance of financial microfinance institutions in Mombasa town, Kenya.

For sustainability, microfinance institutions in Mombasa town, Kenya should not negotiate efficiency of liquidity management. They should uphold and preserve ideal liquidity level in order to satisfy their financial obligations to maximize profitability to the shareholders. Moreover, we can conclude that illiquidity is financial illnesses that can straightforwardly erode the performance of microfinance institution. The search of high profitability without reflection to the liquidity level can cause great distress to microfinance institutions. Consequently, any microfinance institution that has the aim of maximizing its financial performance level must accept effective liquidity management.

It is imperative for the microfinance institution’s management to be alert of its liquidity position in different segments in order to augment competitiveness in the market

**Recommendations**

The study recognized that account receivables indicator as liquidity measures significantly affect the financial performance of financial microfinance institutions in Mombasa town, Kenya. The study recommended that the organization of the microfinance institutions in Mombasa town, Kenya should endeavor to keep an ideal liquidity position that holds acceptable cash resources for operational needs while the excess liquid resources are invested in existing viable investment prospects in the businesses to enhance the growth and financial performance. In addition, management of microfinance should recognize and report other factors that may be affecting their financial performance other than liquidity.

In addition, microfinance institutions in Mombasa town, Kenya spread their investment in other lines of business so as to magnify the income earned. Broadening to of business products may result to expanded income hence more profits for the microfinance. Secondly, the microfinance institutions in Mombasa town, Kenya need to prudently assign and exploit their resources in line with business needs and objectives.

The account payers positively impacts microfinance institutions financial performance and therefore the institutions need to undertake critical assessment of borrowers on their ability to repay loans before awarding so as to minimize cases of high nonperforming loans. The credit policies defined and implemented by the microfinance institutions need to be aligned to business objectives, level of profits expected.

The cash flow positively affects financial performance of microfinance institutions. Microfinance institutions management therefore needs to set strategies and measures that encourage and promote a high level of functioning efficiency. The microfinance institutions can invest on financial technologies to progress operational efficiency. Therefore, these results imply that microfinance institutions management should focus and monitor their operational efficiency and ensure higher operational efficiency. The regulator should ensure that regulatory prudential guidelines on operational efficiency are adhered to in order to protect the interest of the investors.

The study recommends holding sufficient liquidity since it is an enhancer of firm profitability. There should be liquidity efficiency in the microfinance institutions to strengthen confidence of depositors The study also recommends a further study by future researchers on the role of liquidity on a firm’s financial performance by incorporating more liquidity variables.

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