RELATIONSHIP BETWEEN AGENCY COSTS AND FINANCIAL PERFORMANCE OF MICRO-FINANCE INSTITUTIONS IN MACHAKOS COUNTY

BY

NZAU NDETO

A Dissertation Submitted to the Faculty of Business and Communication Studies in Partial Fulfillment of the Requirements for the Award of a Master of Business Administration (MBA) from St. Paul's University

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DECLARATION

This Dissertation is a product of my own work and is not the result of anything done in collaboration. It has not been previously presented to any other institution. I agree that this dissertation may be available for reference and photocopying, at the discretion of the university.

SIGNATURE OF STUDENT _____ DATE _____

NAME: NZAU NDETO

Reg. No: MBA/MKS/6358/15

Word Count: Twenty one thousand, six hundred and thirty three

We confirm that the work reported in this dissertation was carried out by the student under our supervision.

SIGNATURE OF SUPERVISOR 1_____DATE_____

Dr. Paul Gesimba

St Paul's university

P.O Box Private bag-00217

Limuru

SIGNATURE OF SUPERVISOR 2_____DATE_____ Mr. William Sang

St Paul's university

P.O Box Private bag-00217

Limuru

DEDICATION

I dedicate this dissertation to my dear wife Margret and children Mathew, Esther and Annan for the moral support to accomplish the entire work. You accorded me the tools and necessary support during the period of researching on this study. God bless you all.

ACKNOWLEDGEMENT

Most important of all, I extend my gratitude to the Almighty God for the strength and knowledge that helped me undertake this study. I sincerely give my gratitude to my supervisors Dr. Paul Gesimba and Mr.William Sang for their guidance, encouragement and selfless dedication in making this dissertation a reality. You accorded me the necessary support and guidance during this undertaking. May God bless you.

Table of Contents

DECLARATION ..... **ii**
DEDICATION ..... **iii**
ACKNOWLEDGEMENT ..... **iv**
ABSTRACT ..... **viii**
LIST OF TABLES ..... **ix**
LIST OF FIGURES ..... **x**
ABBREVIATIONS / ACRONYMS ..... **xi**
DEFINATION OF TERMS ..... **xii**
CHAPTER ONE **1**
INTRODUCTION **1**
1.1 Background of the Study 1
1.1.1 Agency Costs 3
1.1.2 Financial Performance 4
1.1.3 Agency Costs and Financial Performance 5
1.1.4 Micro Finance Institutions in Kenya 6
1.2 Problem Statement 8
1.3 Research Objectives 9
1.3.1 General Objective 9
1.3.2 Specific Objectives 9
1.4 Research Questions 10
1.5 Significance of the Study 10
1.6 Scope of the Study 10
1.7 Limitations of the Study 10
1.8 Summary of the Study 11
CHAPTER TWO **12**
LITERATURE REVIEW **12**
2.1 Introduction 12
2.2 Theoretical literature 12
2.2.1 Agency Theory 13
2.2.2 Free Cash Flow Theory 14
2.2.3 Stakeholder Theory 15
2.2.4 Pecking Order Theory 16
2.3 Empirical Review 17
2.3.1 Monitoring Costs and Financial Performance 17
2.3.2 Bonding Costs and Financial Performance 19

2.3.3 Residual Loss and Financial Performance 21
2.3.4 Finance Performance 23
2.4 Summary of Literature Review 25
2.5 Research Gaps 25
2.6 Conceptual Framework 26
CHAPTER THREE 28
RESEARCH METHODOLOGY 28
3.1 Introduction 28
3.2 Research Design 28
3.3 The Target Population of the Study 29
3.4 Operationalization and Measurement of Variables 30
3.5 Sample Design and Procedure 30
3.6 Data Collection Instruments 31
3.7 Data Collection Procedures 31
3.8 Data Analysis 32
3.9 Piloting of the Research Instrument 32
3.9.1 Validity of Data Collection Instruments 33
3.9.2 Reliability of Data Collection Instruments 33
3.10 Ethical Issues 34
CHAPTER FOUR 36
DATA ANALYSIS, RESULTS AND DISCUSSION 36
4.1 Introduction 36
4.2 Response Rate 36
4.3 Demographic Information 36
4.3.1 Position in Current Organization 37
4.3.2 Length of Service in Current Organization 37
4.3.3 Length of Service in Micro Finance Sector 38
4.4 Descriptive Analysis of Agency Costs and Financial Performance 39
4.4.1 Monitoring Costs 39
4.4.2 Bonding Costs 41
4.4.3 Residual Loss 43
4.4.4 Financial Performance 45
4.5 Correlation Analysis of Agency Costs and Financial Performance 45
4.6 Regression Analysis of Agency Costs and Financial Performance 46
4.6.1 Monitoring Costs and Financial Performance 46
4.6.2 Bonding Costs and Financial Performance 48

4.6.3 Residual Loss and Financial Performance 50
4.6.4 Monitoring Costs, Bonding Costs, Residual Loss, and Financial Performance 52
4.7 Discussion of Findings 54
CHAPTER FIVE 58
SUMMARY, CONCLUSION AND RECOMMENDATIONS 58
5.1 Introduction 58
5.2 Summary of Findings 58
5.2.1 Monitoring Costs and Financial Performance 58
5.2.2 Bonding Costs and Financial Performance 58
5.2.3 Residual Loss and Financial Performance 59
5.3 Conclusion 59
5.4 Recommendations 60
5.5 Limitations 61
5.6 Recommendations for Further Research 61
REFERENCES 63
APPENDICES ..... Error! Bookmark not defined.
Appendix I: Introduction Letter **.....Error! Bookmark not defined.**
Appendix II: Research Questionnaire **.....** Error! Bookmark not defined.
Appendix III: Secondary Data Collection Tool **.....** Error! Bookmark not defined.
Appendix IV: List of Registered MFIs in Machakos County **..... Error! Bookmark not defined.**
Appendix V: Introduction Letter from St Paul's University **..... Error! Bookmark not defined.**
Appendix VI: Introduction Letter from NACOSTI**.....Error! Bookmark not defined.**
Appendix VII: Introduction letter from Education Office **…….. Error! Bookm**
Appendix VIII: Introduction Letter from County Commissioner**.. Error! Bookmark not defined.**

ABSTRACT

Undeniably, agency cost has emerged as one of the leading determinants of financial performance of a firm. The purpose of this dissertation was to conduct an assessment into the relationship between agency costs and financial performance of Micro-Finance Institutions (MFIs) in Machakos County, Kenya. Specifically, the study sought to investigate the influence of monitoring costs, bonding costs and residual loss on financial performance of microfinance institutions in Machakos County in, Kenya. In order to achieve these objectives, a descriptive design was used. The target population of the study comprised the three MFIs in the Machakos County. To obtain primary data on agency costs, 5- point Likert scale structured questionnaires were ministered to block-holders, finance directors and chief executive officers who were selected through census technique. Secondary data was extracted from the annual reports of the MFIs to determine financial performance. Descriptive statistics such as the mean and standard deviations while inferential statistics included correlation and regression procedures were used to analyze the data. The study found out a significant relationship between monitoring costs and financial performance. Also established was that bonding costs were found to significantly influence financial performance. The study equally established a strong positive correlation between the residual loss and financial performance. The findings were presented using frequency tables. The study recommends that an in-depth investigation should be done on competitive challenges facing the microfinance firms in Machakos county and Kenya in general. Kenya has come of age against the backdrop increased development of mobile phone-based lending platforms which have seriously affected the financial performance of micro finance institutions. The study also recommends that the influence of moderating and intervening factors such as age and size of the firm should be examined, since that was not within the scope of the current study, and more so because the study has adduced mixed results, probably due to the influence of control variables that were not modelled in the study.

LIST OF TABLES

Table 3.1: Target Population……29
Table 3.2: Census contribution……30
Table 4.1: Response Rate……36
Table 4.2: Position in Current Organization……...37
Table 4.3: Length of Service……37
Table 4.4: Length of Service in Micro Finance Sector……38
Table 4.5: Descriptive Statistics on Monitoring Costs……39
Table 4.6: Descriptive Statistics on Bonding Costs……41
Table 4.7: Descriptive Statistics on Residual Loss……43
Table 4.8: Descriptive Statistics on Financial Performance……45
Table 4.9: Correlation between Agency Costs and Financial Performance……...46
Table 4.10: Model Summary on Effect of Monitoring Costs on Financial Performance……43
Table 4.11: Analysis of Variance of Monitoring Costs and Financial Performance……47
Table 4.12: Model Coefficients on the Relationship between Monitoring Costs and Financial Performance……48
Table 4.13: Model Summary for the Effect of Bonding Costs on Financial Performance ….....49
Table 4.14: Analysis of Variance on the Relationship between Bonding Costs and Financial Performance……..49
Table 4.15: Model Coefficients on the Relationship between Bonding Costs and Financial Performance……..50
Table 4.16: Model Summary for Residual Loss and Financial Performance……..50
Table 4.17: Analysis of Variance of Residual Loss and Financial Performance…..…51
Table 4.18: Model Coefficients on Residual Loss and Financial Performance……...51
Table 4.19: Model Summary on Monitoring Costs, Bonding Costs, Residual Loss and Financial Performance……..…52
Table 4.20: Analysis of Variance on Monitoring Costs, Bonding Costs, Residual Loss and Financial Performance…….…….52
Table 4.21: Model Coefficients on Monitoring Costs, Bonding Costs, Residual Loss and Financial Performance…….....53

LIST OF FIGURES

Figure 2.1: Conceptual Framework…….....27

ABBREVIATIONS / ACRONYMS

AMFI	Association of Micro Finance Institutions
CBK	Central Bank of Kenya
CEO	Chief Executive Officer
DTM	Deposit Taking Microfinance
INAFI	International Network of Alternative Financial Institutions
MFI	Microfinance Institutions
SMEP	Small and Micro Enterprise Program
ROA	Return on Assets
ROE	Return on Equity
ROC	Return on Capital
ROI	Return on Investment
SASRA	Sacco Society Regulatory Authority
TSE	Taiwan Stock Exchange
UK	United Kingdom
U.S.A	United States of America
KNBS	Kenya national bureau of statistics

DEFINATION OF TERMS

Agency Costs **:** These are expenses incurred for monitoring, bonding and residual loss (Abdulrahman, 2014)**.**

Bonding Costs **:** These are expenses incurred by the agents to provide assurance to the principal that they are acting in the principal's best interests (Banerjee, Karlan & Zinman, 2015).

Financial Performance: A Firms financial performance can be defined as the measure of how well the firm use assets from its primary mode of business to generate revenues. It measures the financial health of an organization. The common indicators of financial performance are; profits, return on investment, return on assets, value added and margins among others (Amaoko & Goh, 2015).

Microfinance Institutions: These are financial institutions which specialize in banking services for low-income groups or individuals who would not normally be accepted by traditional commercial banks (Tchuigoua, 2015).

Monitoring Cost **:** This is an agency cost that arises when shareholders take steps to ensure that protective covenants in the bond agreement are adhered to by the management (Osman, 2014)**.**

Residue Loss **:** This expense occurs whenever the actions that would promote the self-interest of the principal differ from those that would promote the self-interest of the agent, despite monitoring and bonding activities (Nobanee, Ellil and Abraham, 2017).

Return on Investment **:** This is a performance measure used to evaluate the efficiency of an investment (Adhikary & Papachristou, 2014).

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

An agency relationship occurs when a principal hires an agent to perform certain duties on his/her behalf. A conflict known as agency problem arises because of the divergent interest between the needs of the principal and those of the agent. This problem leads to certain expenses from both antagonistic parties. Agency costs arise as a result of conflict of interest between shareholders and the company's managers. A shareholder in the normal operations of the organizations activities wants the manager to make decisions which will increase the shareholders value. However, managers instead would prefer to expand the business and increase their earnings, which may not necessarily increase shareholders value.

Originally, agency problem was raised by Jensen and Meckling (1976) who stated that, lack of consistent interest in the needs of shareholders and management leads to agency costs. Indeed, separation of management and ownership does not come without costs. Alabdullah (2016) argued that lack of complete contractual relationship between the needs of the agent and the principal might cause agency problem. Further, Nobanee, Ellil and Abraham (2017) stated that performance can be defined as end results and achievement, positive or negative outcome of an activity carried out by an organization.

Agency costs is the cumulative of three types of costs that characterize agent operations or functionality which include monitoring costs, bonding costs and residual loss (Adhikary & Papachristou, 2014). Costs of monitoring are those spent on making follow-up or evaluating all the management processes or activities the agent carries out in the company on behalf of the owners. Generally, such compensation or payment made for monitoring, remunerating and assessing the performance of the agent or manager who runs the company constitute agency costs. Equally, agency costs include those that compensate the board of directors, expenses spent to hire, develop as well as train staff (Banerjee, Karlan & Zinman, 2015).

On the hand, costs being referred to as bonding are incurred by the managers or agents in discharging contractual responsibilities or mandate to impress their bosses (principals). Such costs are incurred to carry out their roles meant to ensure the owners achieve their desired goals. Usually, bonding expenses are utilized to establish and function according to a definite structure or system. The two types of costs discussed above take divergent direction in that increased bonding costs should lead to decrease in monitoring costs.

The conflict of interest between the shareholders and managers results in another problem, where the decision taken by the managers are not aligned to maximize the wealth of the owners (Biwott, Asienga, Oketch & Mutai, 2015). These inefficient managerial decisions lead to a loss known as the residual loss. Alabdullah (2016) elucidated that the residual loss is the key component of the agency cost, which should have to be reduced by the principals. To reduce the residual loss, the owners incur monitoring cost and bonding cost. Hence, these costs have become the whole of the irreducible agency cost.

Financial performance can be measured using different ways of which all should be taken in aggregation. Items such as operating income, revenue from operations and cash flow from operations can be used as total unit sales. Ratios such as return on investment (ROI), return on assets (ROA) and return on equity (ROE) can be used by the financial analyst to seek out declining debt or marginal growth rate of the firm.

There are several theories that have been put across to explain the relationship between agency cost and financial performance of a firm. These theories include: agency theory, stakeholders theory, free cashflow theory and the pecking order theory. According to agency theory as it was propounded by Jensen and Meckling (1976), managerial actions depart from shareholders interest of maximizing return hence leading to agency problem. As shareholders are concerned about the health performance of the firm and promising returns, the management and employees of the company are interested with their allowances and salaries resulting into conflicting interests.

Another theory is the stakeholder theory as it was put forward by Freeman (1984). According to Miradji (2014) shareholders may take an action against the managers of the firm due to failure to perform their required duty of care. Olarewaju (2017) defined stakeholders as groups which are important for success and survival of the firm. Another theory is free cashflow theory. According to Lachheb and Slim (2017), too much free cash flow will result to the waste of cooperate resources and internal insufficiency hence leading to agency cost becoming a burden to shareholders wealth maximization goal.

The last theory is the pecking order theory which was propounded by Myers (1984). Myers argued that retained earnings are better than debts and debts are better than equity. According to Abdulrahman (2014), pecking order is a special case of adverse selection. When the firms value is undergoing adverse selection, firms decide to issue debts over outside equity hence standard pecking order model apply. However, when there is information about risk, adverse selections for debt apply and hence firms prefer to issue external equity over debt.

1.1.1 Agency Costs

Abdulrahman (2014) defined agency costs as expenses incurred by the principal for monitoring, bonding and residual loss. Additionally, Okundi (2011) defined agency costs as the sum total of bonding costs, monitoring costs and residual loss. Basically, there are three types of agency costs which include, monitoring, bonding and residues loss. A study done by Bortych (2017) argued that there is a good reason to belief that the agent will not always act in the best interest of the principal. In order to limit the agent from divergences from the principal's interest, the principal puts checks and balances which are referred to as monitoring costs (Bortych, 2017). Some of the monitoring costs include, staffing costs, budget control costs, auditing costs, compensation costs (cash &equity), additional layers of management, directorship (block holders) costs, indenture costs and contract enforcement costs among others.

In certain situations, there is a payment to the agent bonding costs in order for the agent not to act in a way that can harm the principal. Such costs include, advertising

expenditures, license fees, asset utilization costs, accounting costs, travel and vehicle expenses, maintenance and repair costs, attorney fees and legal fees, utilities, such as telephone.

According to Abdulrahman (2014), residual loss is also an agency cost of the agency relationship experienced by the principal. Costs such as perks beyond remuneration package, expanded workforce, high debt ratio, wasteful expenses, higher interest expense, higher equity costs, are some of residue costs. The importance of agency costs is to help to mitigate the effects of agency problem. Agency problem are the difficulties faced by shareholders or stakeholders in ensuring that their funds are not wasted on unprofitable projects (Osman, 2014). This makes financiers gain financial benefit from their organization.

According to Xiao (2009), computing the asset utilization ratio is one major way of measuring agency cost. Similarly, according to Abdulrahman (2014) agency costs due to conflicts between managers and shareholders is a loss which means the agent consumes various benefits from the firm to maximize his own interest.

According to Machuki and Aosa (2011), one party delegates work and the other party performs the duty on behalf of the principal. According to Odhiambo (2012), analysis of agency costs generated from the conflict between manager and shareholders can be reduced by increasing the owner-managers proportion in equity. Okundi (2011), opines that agency problem arises due to the impossibility of perfect contracting of an agent whose actions affect the welfare of the principal. Therefore, the principal agent antagonistic relationship is attributed to conflicting interests of each party.

1.1.2 Financial Performance

According to Abdulrahman (2014), financial performance is defined as how well a firm uses its primary resources to generate revenue. It involves measuring firm policy results and monetary terms by allocating resources to the most profitable projects that will generate income which will maximize shareholders' wealth. According to Tchuigoua

(2016) performance can be defined as end results and achievement, positive or negative outcome(s) of an activity carried out by an organization. Financial performance is used to determine or gauge how a firm maximizes the assets it has to produce returns (Quayes, 2015).

Additionally, Adabenege and Yahaya (2015) suggested that for a firm to obtain funds for expansion and growth and also to sustain business operations, it must earn sufficient profits. The financial health of a firm for a period of time is measured using financial performance. It also compares the performance of industries in aggregation or performance of firms in an industry.

On the other hand, Acharya, Dupatti and Locke (2015) observed that different methods can be used to determine the performance of a firm in terms of finance which should be considered cumulatively. Some items like operating income, profits emanating out of processes as well as cash-flow gotten from operations, should be utilized as overall component sales. Ratios such return on investment, return on assets and return on equity are used by the financial analyst to seek out declining debt or marginal growth rate of the firm.

1.1.3 Agency Costs and Financial Performance

The underlying theoretical base of agency theory explains the relationship between financial performance and the agency costs. The theory states that compensation should be contingent and should be of more than one performance measure (Abedifar, Hasan & Tarazi, 2016). The researcher further pointed out that the relative importance of performance measures should be sensitive to manager's performance.

Ahmed, Bhuiyan, Ibrahim, Said and Salleh (2016), in their work in Malasya, asserted that firms from overseas record higher agency related costs due to policy of these firms to employ highly qualified managers to do best auditing because the principals are far. Butcher & Galbraith (2015) concured with the assertion that higher auditing charges than

local firms are outcomes of complex financial reports framework or system of foreign holding or subsidiaries as well as strict adherence to corporate governance principles.

The existing theories on agency costs resulted in different findings and conclusions. Firstly,Casselman, Sama and Stefanidis (2015) observed reduced agency costs are attributed to a board that is independent. Wijesiri, Yaron and Meoli (2015) found a positive correlation between audit committees and managers 'competence and low agency costs. Lacalle-Calderón, Chasco, Alfonso-Gil and Neira (2015), and Butcher & Galbraith (2015) observed that agency cost reduces where remuneration as well as nomination committees exist. Furthermore, Kiaritha (2015) established a strong relationship exist between agency costs and capital structure of firms.

Wangai, Bosire and Gathogo, (2014) found weak relationship between agency costs and capital structure of firms. Kleynjans and Hudon (2016) reported a strong positive correlation between the ratios of asset turn over. Hoepner, Liu, Sandberg and Wilson (2017) found out that the duality of a chief executive officer does not lead to high returns. Wijesiri, Yaron and Meoli (2017) found a strong positive correlation between family-owned and managed companies' agency costs and performance. Additionally, D'Espallier, Goedecke, Hudon and Mersland (2018) observed a free cash flow increases agency costs.

According to Ali (2015), many economic factors affect financial performance hence it will be insensitive to link this to the managers actions. On the other hand, accounting measures can be created to capture different aspects of an organization circumstances and appear to cater in both long term and short-term aspects of performance which are not well captured by either relative or general measures of stock return (Micro Finanza Rating, 2015).

1.1.4 Micro Finance Institutions in Kenya

The number of Micro-finance institutions increased in Kenya as a result formal commercial banking institutions excluding majority of low income earning Kenyans from

banking services (World Economic Forum, 2015). Lending institutions such as microfinance institutions offer services which allow Kenyans to invest and save on the available resources and assets. The MFIs are more accessible to the majority low income earners than the commercial banks which favour high income earners and not available in most rural areas of Kenya where the majority of Kenyans live.

This further enhances and facilitates the growth of economic activities in Kenya through provision of finances and working capital to small business people. The key role of microfinance institutions in Kenya is to bridge the gap in the financial services industry. This is achieved by offering micro-loans (small loans) to borrowers who may lack the qualifications and collaterals for conventional loans (Muiruri, 2014). Additionally, these institutions offer access to financial services to communities with limited resources and limited avenues of economic development.

The MFIs also offer avenues for saving and borrowing for small business and medium business holders at affordable rates. The MFIs offer asset financing to customers whereby the beneficiaries are able to acquire and use an asset as they repay in instalments. Micro finance institutions play a key role in Kenya's landscape of financial intermediation focusing mostly on small and micro enterprise sector of the economy and also personal development. The MFIs have impacted positively to the economic wellbeing of most Kenyans through access to affordable credit and assets though asset financing.

Medium and small business holders in Kenya can apply for these micro-loans to establish small businesses with regards to their skill sets or talents (Munene, 2014). These MFIs are regulated by the CBK (CBK, 2015). According to the Central Bank of Kenya (CBK, 2017) and Capital Market Authority (2015), by 2015 Kenya had about 65 fully licensed MFIs of which 51 were offering retail services and the rest wholesale. Besides, 269 branches made up a strong MFIs network where 105 were Deposit-Taking (DPM) while 164 offered credit-only services. Jointly, MFIs control a whopping 1.47 million accounts of deposit in nature with a value of Kenya shillings 32.04 billion with an unpaid loan range estimated at Kenya shillings 34.77 billion (CBK, 2016).

The geographical scope of this current study, Machakos County, is home to three MFIs franchises which had been licensed and operating in the last five years at the time the study was conducted. These included, Faulu Microfinance Bank Ltd, Kenya Women Microfinance Bank Ltd, and SMEP Microfinance Bank Ltd. However, the CBK annual report of the year ending 2017, painted a grey picture of a 10%, 8% and 11% declining return on asset, return on investment and return on equity respectively among the MFIs branches in Machakos County (CBK, 2017). Worse, despite Machakos County's close proximity to the Kenya's capital city Nairobi that hosts over 60 MFIs, the later hosting only 3 MFIs, points to possible environmental issues hindering MFIs' penetration.

1.2 Problem Statement

Undoubtedly, Stakeholders incur cost to keep managers remain focused on maximizing shareholders interest. Despite the huge investments by the shareholders on MFIs in expectation of better returns, the management goals of earning better salaries and allowances are in conflict to the shareholders goals. According to Gulubov and Xiong (2016), management is tempted to pursue selfish strategies when firm has debt hence imposing agency costs on the firm.

Despite the importance placed on MFIs, available empirical literature consists of solid an undesirable connection between agency costs and financial performance of MFIs in Kenya (Mukulu, Rukaria & Sakwa, 2015). However, agency costs have negatively impacted MFIs such as lowering the market value, ROA, ROI, ROE and return on capital. For instance, the CBK annual report of the year ending 2017, painted a grey picture of a 10%, 8% and 11% declining return on asset, return on investment and return on equity respectively among the MFIs branches in Machakos County (CBK, 2017).

Despite the negative performance associated with agency costs in microfinance institutions, there seems to be scarcity of research in this field. To that end, most of these studies are contextually based abroad especially the developed countries. Locally, previous research in this area have dwelt on the banking sector as a whole, Commercial

banks and microfinance institutions on aggregate (Muriithi, & Waweru, 2017; Otieno, Nyagol & Onditi, 2016; Mwangi, Shisia, Mwai & Okibo, 2014). Besides, not much research has been done to establish how agency costs are related to the performance of finances specifically for Microfinance Banks in Machakos County in Kenya.

In order to fill this gap, the current study sought to find out the relationship between agency costs and financial performance MFIs in order to act as a guide to microfinance stakeholders in controlling agency costs as they pursue good financial performance for institutions they manage. Since it is not logistically possible to survey all MFIs in Kenya, special reference was given to MFIs in Machakos County.

Principally, the present study strived to fill the contextual and conceptual empirical evidence insufficiency by contributing to governance of corporates in this case MFIs in Kenya. Additionally, probing the influence of agency costs on financial performance, the regulatory regime is likely to improve these aspects. The outcomes of this research should enlighten shareholders and other stakeholder on better agency principal relations among MFIs.

1.3 Research Objectives

1.3.1 General Objective

The main objective of this study was to investigate the influence of agency costs on the financial performance of micro finance institutions in Machakos county.

1.3.2 Specific Objectives

(i) To examine the influence of monitoring cost on financial performance of microfinance institutions in Machakos county.

(ii) To determine the influence of bonding cost on financial performance of microfinance institutions in Machakos county.

(iii) To establish the influence of residual loss on financial performance of microfinance institutions in Machakos county.

1.4 Research Questions

The study sought to answer the following questions:

(i) What is the effect of monitoring costs on financial performance of microfinance institutions in Machakos county?

(ii) What is the effect of bonding costs on financial performance of microfinance institutions in Machakos county?

(iii) What is the influence of residual costs on financial performance of microfinance institutions in Machakos county?

1.5 Significance of the Study

Essentially, the study is expected to provide information to micro-finance institutions regulatory authority and other policy makers in formulating policies that enhance the performance of MFIs in Machakos county and also Kenya at large. The study might also help the management of MFIs in formulating strategies that may lead to increase in size of the variable that would lead to positive financial performance.

To the micro-finance institutions customers, they would appreciate the effect of their savings on financial performance of the MFIs. The study might also form a basis for further research for scholars and researchers on the effects of financial performance of micro finance institutions. It would add value to the existing literature in implementing strategic change initiative in MFIs in Machakos county and to other in Kenya.

1.6 Scope of the Study

Conceptually, this study set out to evaluate the influence of agency costs on the financial performance of MFIs. Geographically, the study was conducted in Machakos county. The study targeted three micro finance institutions based in Machakos county and licensed by the Central Bank of Kenya.

1.7 **Limitations of the Study**

Notably, the current study was limited in some ways that need to be evaluated before the findings are considered. Firstly, it was delimited on MFIs in Machakos county in Kenya,

considered only three variables of agency costs as determining factors of the financial performance of MFIs hence might have ignored other critical factors that may have affected financial performance of the MFIs in Machakos county. In addition, the study was confined to the Machakos county hence the findings of the study may not be generalizable across the country due to contextual factors.

Likewise, using ROI as determination of finance performance was narrow measurement and therefore it might not be a true representation of the efficient financial performance in the MFIs in the county. There were also limitations of using samples and therefore care was taken to ensure that the sampled respondents were representative of the population in order to arrive at reliable generalizations.

The study also took into consideration the financial indicators to determine the performance of MFIs, whereas, there could be non-financial indicators of performance. The MFIs might have reservations that the findings of the study could be divulged to their competitors to their disadvantage; however, respondents were assured the study was meant for scholarly purposes exclusively. Moreover, the process of obtaining secondary data was time consuming due to the bureaucracies involved.

1.8 Summary of the Study

This chapter comprises the background to and motivation for the study. It further highlighted global, regional and local perspectives of the research problem in addition to the problem statement, research questions and research objectives. Secondly, the scope, the significance and limitations of the study was provided. Further, a conceptual analysis of key concepts used and profile of the study area was equally given attention in this section of the current study.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviewed both theoretical and empirical literature pertaining to the study problem. Whereas the theoretical literature focused on the theories and models underpinning the study, the empirical literature reviewed previous scholarly work in relation to the present research objectives. The contributions of previous scholars as well as the gaps thereof were also explored. Finally, the conceptual framework showing relationship among variables were also presented.

2.2 Theoretical literature

The theoretical framework is the structure that can hold or support a theory of a research study. The theoretical framework introduces and describes the theory that explains why the research problem under study exists. Theories are formulated to explain, predict, and understand phenomena and, in many cases, to challenge and extend existing knowledge within the limits of critical bounding assumptions. Without a theoretical framework, the structure and vision for a study is unclear, much like a house that cannot be constructed without a blueprint. By contrast, a research plan that contains a theoretical framework allows the dissertation study to be strong and structured with an organized flow from one chapter to the next (Ravitch & Riggan, 2017).

There are various theories that develop or shade light on the key variables being examined in the current study. These theories strive to give adequate explanation of the relations existing relations between agency costs and financial performance. These theories include: agency theory; free cash flow theory; stakeholder theory; and the pecking order theory.

2.2.1 Agency Theory

This theory was advanced by Jensen and Mecklings (1986). According to Goergen and Renneboog (2014), firm's owners give professional managers to manage their firms. Meyer (2015) stated that agency problem arises when managerial action departs from maximizing shareholders return. Agency theory aims at resolving problems that occur in the relationship between agent and the principal (Mori, Golesorkhi, Randoy & Hermes, 2015). Nasrin, Rasiah, Baskaran and Masud (2017) suggest that agency theory rests on assumption that firms should aim at maximizing shareholders wealth.

Tchuigoua (2015) argued that, agency costs are incurred by the principal to ensure that manager's actions are based on maximizing shareholders return. There are two main concerns that are involved in the principal agent relationship. The first concern is the expense the principal incur when monitoring the agent routine actions while second concern is the divergent attitudes held by the agent and the principal towards risks.

However, agency theory has received some criticism. The principal makes prescriptions and predictions of management to control the behavior of the agents. This is done through imposing internal controls so as to minimize the agency cost so as to maximize the wealth of principal. The lack of general empirical support for an agency relationship between the principal and management suggest at least two responses (Wooldridge, 2014).

This theory is relevant to the present study by imploring the MFIs management to focus more on process rather than structural issues can lead to profit maximization. The second relevance is based MFIs management on improving firm performance by aligning the goals of the MFIs owners and the goals of the management to minimize principal-agent conflict. A motivated management will strive to achieve long term success which will benefit the principal (Mishkin, 2016).

This theory has been criticized on grounds that it has a narrow and biased approach that only delved one part of the agent as the one that is to blame for agent-principal conflict

ignoring the principal that equally has the potential of creating or contributing to the conflicts. Indeed, the principal, like the agent, takes advantage, cheats and dodges his/her employee (the agent) (Livnat, Smith, Suslava & Tarlie, 2016). Furthermore, principals cunningly and opportunistically drag unsuspecting agents into risky unclear or ambiguous work contract.

Secondly, this theory takes for granted employment contract between the two parties that lacks time frame thereby bringing in the element of uncertain of the future of the agent. Worse, the assumption of this theory of contract agreement addressing or doing away with agency conflict is hampered by information sharing disproportionateness, shrewdness, swindle as well as and contract expenses or cost. This is deceptive and because while the principals expect maximization of their investment through massive returns, their engagement in the operations or management of the enterprises is very insignificant (Bortych, 2017).

2.2.2 Free Cash Flow Theory

Narwal and Jindal (2015), recalled that the idea of free cash flow was proposed by Jensen (1976). The scholars defined free cash flow as the remaining liquidity (cash flows) when the needs of positive net present value ventures get subtracted. Management of the organization is the one which is responsible to allocate free cash flows hence it is also referred to as idle cash flows.

Too much free cash flow can lead to waste of corporate resources and internal insufficiency hence resulting into agent related expenses (costs) being a liability to shareholders' treasure or prosperity. Additionally, too much cash flow in an organization could lead to spending outside the budgeted amounts by the management thus affecting the financial performance of the organization and returns to the shareholders at the end of the financial period.

Quayes (2015) argued that in the 1980's free cash flow is blamed for drastic decline of ROI beyond normal rates in US companies. In addition to free cash flow, the theory

argued that self-interest motive of the management of the organization is the key driver of agency costs. This is obvious when management and shareholder interests collide or conflict that leads to management interest always dominating the shareholders interest consequently.

Free cash flow theory has also some weaknesses. It states that organization with substantial free cash flow in most of the times tend to face conflicts of interest between managers and stakeholders. Once managers are satisfied with obligations contracted by the firm with cash flow generated by operations, managers use the remaining cash flow for their own benefit instead of the interest of shareholders (Narwal & Jindal, 2015).

This theory is very applicable to the current study in the sense that the management of MFIs having a lot of free cash at its disposal could tempt them to spend on non-essential that have not been factored into the budget. In all cases, such expense is usually to the benefit of the management to satisfy their personal interests. Consequently, such expenses increases agency costs at the expense of the owners of MFIs.

Amaoko and Goh (2015) maintained that firms with excess cash flow have high agency costs. Managers invest the excess free cash flow in projects which are non-value maximizing. The firm owners with more free cash flow monitor the activities of the management to avoid wastage of resources. This monitoring increases the firm cost of monitoring hence increasing the agency cost of the firm. The researcher also stated that, high level of leverage in the capital structure of the firm also increases the firm's bankruptcy risk.

2.2.3 Stakeholder Theory

According to Ronzoni and Valentini (2015), this theory was advanced by Freeman (1984) who defined stakeholder as any individual or any group which can affect the achievement of the set objectives of the organization. Over time, the father of stakeholder concept changed the definition of stakeholder. According to Ronzoni and Valentini (2015) stakeholders are those groups or individuals who are crucial and determine an

organization's performance, existence and continuity. The author added a new principle which portrays a new trend in stakeholder theory.

Stakeholders may bring an action against the board of directors for failure to perform their action of duty of care. The management of any firm should have the shareholders interest at all the time during their daily operations in achieving the stakeholder objectives. The theory articulates that management should be more sensitive towards achieving the interest of the shareholder for a long-term sustainability and financial performance of the enterprise.

However, stakeholder theory has also received some criticism. Different stakeholder groups do not share a common commercial purpose. Some may want a company to grow, some may want it to be taken over, and some may want the company to maintain its present size and many others. As a result, the purpose of a company may be frustrated. In addition, competition does not loom large in stakeholder theory. The competition of the company should be stakeholders since they are affected by achievement of companies' objectives. Also, stakeholder theory does not show how stakeholders can be represented (Ronzoni and Valentini, 2015).

2.2.4 Pecking Order Theory

According to Lachheb and Slim (2017), the pecking order theory was put forward by Myers and Majluf (1984) argued that debt is better than equity and reserved incomes supersede liabilities such as debts. The idea behind the adverse selection model is that, managers and owners of organizations know the growth opportunities and the exact asset value.

Incidentally, shareholders not on the board of directors can only conjecture or speculate such asset value. If a manager wished to sell equity, outside investors ask themselves, why is the manager willing to sell the equity? Manager of an undervalued firm will not be happy to sell equity while manager of overvalued firm will be happy to do so. Chan and

Lin, (2015) argue out that some agency theory versions infer hierarchical funding or financing. Pecking order can be as a result of agency cost of equity.

According to Lachheb and Slim (2017), a special case of adverse selection is the standard pecking order when firm's value is having adverse selection, the firm favors debt outside equity issuance hence selection arguments for debt apply when there is a symmetric information about risk and hence companies make the choice of issuance of outside equity rather than debt. Choosing adversatively, often results into favoring outward equity (outside debt) that is predicated on either lopsided information issues are related to risk or value.

The pecking order theory has also some criticism. It does not explain the influence of financial distress, taxes, agency costs, security, insurance costs and the set of opportunities available for firm investments. The pecking order theory it also ignores the problems that can arise when managers of the firm accumulate so much discipline. Due to this reason, the pecking order theory is offered as a complement to the traditional trade off model rather than a substitute for the traditional trade off model.

2.3 Empirical Review

This section presents previous studies in the area of study. Secondly, it's from the review of empirical literature that the research hypotheses have been developed for further investigation.

2.3.1 Monitoring Costs and Financial Performance

The monitoring costs are a type of agency cost that originated from principal and agent theory emerged in the 1970s from the combined disciplines of economics and institutional theory. Theorist Stephen Ross is credited to have originally come up with the idea and later developed by Barry Mitnick. However, the most cited reference to the theory comes from Michael Jensen and William Meckling (1976). When the principals attempt to monitor or restrict the actions of agents, they incur expenses referred to as monitoring costs.

Some MFIs choose to monitor holdings especially abroad by employing personnel from their own countries to run their branch business abroad. The aim here is to ensure the shareholders maximize return on investment since the hired staff are fellow countrymen are most likely keen not to betray principals who are their own people (Cull, Navajas, Nishida & Zeiler, 2015).

Typically, MFIs in Japan, have embraced this model of hiring their fellow countrymen as high and middle cadre managers to run their foreign subsidiaries. They effectively monitor their subsidiaries abroad through such like-minded countrymen. Meyer (2015) suggests additional non-staff monitoring strategies such as establishing elaborate systems of budgeting, extra managerial cadres and boards. Nevertheless, maximization of local personnel is prudent given hosting countries' restrictive foreign employee polices.

Similarly, Quayes (2015) advises MFIs to embrace audit as an additional strategy of monitoring agents. The author asserts that mechanisms such as auditing, authenticates or validates operations and decisions of the affiliates are in tandem with interests and aspirations of the shareholders. Ahmed, Bhuiyan, Ibrahim, Said and Salleh (2016), in their work in Malasya, assert that firms from overseas record higher agency related costs due to policy of these firms to employ highly qualified to do best auditing because the principals are far.

This view is shared by Bortych's (2017) findings in a research conducted in the USA which established that MFIs hire high-end quality auditing officers. Studies reveal MFIs operating in many countries, release more detailed financial reports than firms that operate exclusively in a single country (Blanco-Oliver, Irimia-Dieguez & Reguera-Alvarado, 2016). Understandably, reports with more details emanate from more aspects or items to be audited requiring more auditing input in terms of time and human effort. As a result, auditors charge more fees for such massive work culminating in increased agency costs.

Butcher & Galbraith (2015) concurred with the assertion that higher auditing charges than local firms are outcomes of complex financial reports framework or system of foreign holding or subsidiaries as well as strict adherence to corporate governance principles. Besides, the requirement to have financial reports in many languages, inter-state currency transactions and transfer fees, requires extra auditing which increases auditing fee.

Casselman, Sama and Stefanidis (2015) attributed mechanisms of monitoring to global MFIs corporate governance competition. Increased competition dictates more caution of parent firms to relax stringent systems and decentralize control to enable affiliates to survive stiff competition. This validates auditing to check decentralized control so that it is not abused in the subsidiaries and ensure interests of shareholders are not compromised.

Daher and Saout (2015) identified with the above line of thought who found an MFI requires solid guarantee mechanism that can only be provided by an external auditor who is autonomous that the company cannot influence. Indeed, an outside auditor is more the one employed in the company. As such auditing role becomes crucial and more dependable than even directors on the board.

2.3.2 Bonding Costs and Financial Performance

Bonding costs are a form of agency costs that originated from principal and agent theory that emerged in the 1970s from the combined disciplines of economics and institutional theory. Theorist Stephen Ross is credited to have originally come up with the idea and later developed by Barry Mitnick. However, the most cited reference to the theory comes from Michael Jensen and William Meckling (1976) who argued that bonding costs are incurred when the agent (management team) uses the company's resources for his or her own benefit.

According to agency theory, structure of ownership contributes significantly to reduced agency costs. Equally, Fratini and Tettamanzi (2015) and Ibrahim, Ahmed and Minai

(2018) have the view that agency costs can decrease by increased number of firm owners being part of the board of directors. The argument is that more directors on the board of directors increase monitoring chances.

According to the agency theory institutional type of company ownership brings down agency costs due to strictly laid down operational systems. In their study conducted in the UK, Ahmed, Bhuiyan, Ibrahim, Said and Salleh (2016) established that block-holders (concentrated type of ownership) equally scales down agency costs. However, Bortych (2017) established that the concentrated form of company ownership has been found not to lower agency costs in Indonesia but a company that is family owned, puts agency costs in check. On the other hand, there was no positive correlation between block holders have and decreased agency cost.

Similarly, D'Espallier, Goedecke, Hudon and Mersland (2017) revealed zero agency cost among companies where the owner doubles as the manager because this structure ensures the alignment of both the owners and managers' interests. This is because employees receive dividends from company increased returns. On the contrary, listed public enterprises which are owners are not part of the management with the latter being outside managers. Proponents of agency theory hold the view that agency costs are considerably lowered by effective governance.

The researchers in their study determined that big as well as influential boards of directors offer very effective governance. On the other hand, Mishkin (2016) companies are properly governed by lesser or boards with less directors. Nurmakhanova, Kretzschmar and Fedhila (2015) associated less agency cost with a board consisting more directors but Randoy, Strom and Mersland (2015) established the contrary in the sense that the less the directors of a board the less the agency costs. Casselman, Sama and Stefanidis (2015) observed reduced agency costs are attributed to a board that is independent.

Wijesiri, Yaron and Meoli (2015) found a positive correlation between audit committees and managers' competence and low agency costs. Lacalle-Calderón, Chasco, Alfonso-Gil and Neira (2015), and Butcher and Galbraith (2015) observed that agency cost reduces where remuneration as well as nomination committees exist. Furthermore, Kiaritha (2015) carried out a study to determine whether there is a relationship between agency costs and capital structure of firms listed in Nairobi stock exchange.

The study which concurred with a study carried by Wangai, Bosire and Gathogo (2014), also investigated whether use of debt in capital structure can minimize the conflict between managers and shareholders. The total population of the study included all companies in Nairobi stock exchange between the year 2012 and 2013. Statistical power of excel was used to analyze the data where the findings indicated weak relationship exist between agency costs and capital structure of firms in Nairobi stock exchange. It was also concluded that, use of debt increases asset utilization in low growth firms and decreases expenses in high growth firms. Generally, diverse governance forms are utilized in addressing the agency conflict or problem.

2.3.3 Residual Loss and Financial Performance

Residual loss is a category of agency cost that originated from principal and agent theory in the 1970s from the combined disciplines of economics and institutional theory. Theorist Stephen Ross is credited to have originally come up with the idea and later developed by Barry Mitnick. However, the most cited reference to the theory comes from Michael Jensen and William Meckling (1976) who asserted that Residual loss are costs emanating from divergent principal and agent interests despite the use of monitoring and bonding.

Additionally, Kleynjans and Hudon (2016) carried out a study among 505 companies at the Taiwan Stock Exchange (TSE) between 2013 and 2014 on the relationship between free cash flow and agency costs. Performance of a company was operationalized as ROA and ROE. The findings showed a strong positive correlation between the ratio of asset turn over and performance of a firm in terms of ROA and ROE. Also, operating expenses

to sales ratio were found to influence company performance operationalized as ROA and ROE.

On the other hand, Hoepner, Liu, Sandberg and Wilson (2017) conducted a study on the influence of the duality of a chief executive officer on company performance and had findings in consistent with agency theory's assumptions that asserts the duality of a CEO does not lead to high returns. Randomly, sampling 40 companies from Fortune 500, García-Meca, García-Sánchez and Martínez-Ferrero (2015) studied companies with CEO quality or CEO as chair with full independence annually between 2009 and 2013.

It was established that firms with such system experienced increased ROE, ROI as well as higher profitability. However, Banerjee, Karlan and Zinman (2015) observed the reverse and suggested more inquiry into influence of board structure on returns. Elsewhere, Wijesiri, Yaron and Meoli (2017) found a strong positive correlation between family-owned and managed companies' agency costs and performance. The research design was a cross- sectional survey which targeted a total of 37, 301 CEOs of family owned companies in the US. The firms selected as the sample had average annual sales of $36million, with 195 employees and had been in businesses for 49 years.

The data indicated a positive relationship existed between performance for non-family pay incentives but not the reverse. The findings showed that strategic planning had a positive impact on performance while CEO tenancy had a negative effect on organization performance. Aribi and Arun (2015) studied the effect of unutilized liquidity combined with moderating effect of agency costs on firms trading at the Telavi Stock Exchange, in Israel. Using randomly sampled 143 firms were investigated between 2006 and 2011, and agency costs operationalized through efficiency ratio while free cash flow was determined through the model of Len and Paulse. The study observed a free cash flow increases agency cost.

Ayuma, Namusonge and Iravo (2015) did a study to investigate the salient aspects and the nature of agency relationship between the public universities in Kenya as an agent and the government as the principal for the provision of higher education. Six

commissioned public universities were selected where semi structured questionnaires were sent to each university. The data was analyzed using tables, proportions and percentages. Findings depicted an agency relations between higher institutions of learning and the government are direct and are expressed in form of policy, parliamentary legislation, establishment, financing higher education, collaboration and research.

Similarly, Biwott, Asienga, Oketch and Mutai (2015) sought to establish if agency cost as well as some determinants of managerial behavior had influence on firm performance in Kenya. A sample of 27 firms from three economic sectors namely banks, industry and services were used. The research observed a non-linear, and a substantial correlation amongst an agency cost of ownership and the managerial ownership on such a relationship is affected by firm performance Kahuthu, Muturi and Kiweu (2015) examined the impact of prices of stock quoted in Nairobi stock exchange on agency cost. The researcher used secondary data from annual financial reports from authorized data vendors by the Nairobi stock exchange council. Descriptive statistics was used to present the data. In addition, quantitative analysis was conducted to give meaning to the data results. The revealed a strong positive correlation between the agency costs incurred by public companies and the price of their stock.

Mwangi, Shisia, Mwai and Okibo (2014) did a study to establish whether agency related cost have a relationship with the divided policies from companies quoted in Nairobi stock exchange. A target of 54 companies quoted in Nairobi stock exchange used. Descriptive approach that maximized stratified random sampling. A sample of 20 companies out of population of 54 companies was picked for a period of 8 years from 1999 to 2006. It was found dividend policies of the firm do not seem to be designed to mitigate the agency costs of the firm.

2.3.4 Finance Performance

Studies on financial performance should include multiple criteria analysis. Thus different models or patterns of relationship between financial performance and its determinants should be used to demonstrate the various sets of relationships between the dependent

and the independent variables in the estimated models (Shahzad, Ali, Ahmad and Ali, 2017). These researchers reported that agency cost has positive effect on financial performance while studies such as the ones of John (2018) reported otherwise. However, the results that could be obtained from developing economies like Nigeria may be quite different given the differences in the nature of economies and the level of sophistication in the monitoring mechanisms.

Additionally, Zabri, Ahmad and Wah (2016) pointed out that larger firms generate superior performance relative to smaller firms. A firm's demographic characteristic such as number of outlets and the age or life stage of the firm as well as board size are seen by some researchers as driver of financial performance. If there are economies of scale, a larger number of outlets mean a better performance due to the incurring of agency costs such as monitoring costs, if not, more outlets lead to a worse performance. In a study on retail banks, Barnett et al. (1994) find single unit banks performing better. They argue that a firm's emphasis on market positioning retards organizational learning.

Secondly, Grazzi, Jacoby and Treibich (2016) set out to establish that a positive relationship exists between agency costs incurred by family firms and performance. The research design was a cross sectional survey which targeted a total of 37, 301 chief executives of privately held U.S.A family businesses of which a sample of 1376 firms was selected. The firms selected as the sample had average annual sales of $36million, with 195 employees and had been in businesses for 49 years. The data indicated a positive relationship existed between performance for non-family pay incentives but not for family pay incentives. The data also showed that strategic planning was positively related to performance and CEO tenure was negatively associated with firm performance, average board tenure and outside directors.

Ahmar, Rahman, Arifin and Ahmar (2017) studied the effect of free cash flows and agency costs on the performance of listed companies in Tehran Stock Exchange. A sample of 140 companies were selected during the time span from 2009-2016. Efficiency ratios were used as measures of agency cost and Len and Paulsen model issued to

measure free cash flows. F-Limer and Hausman tests were used to appropriate estimate of models for selecting among one of methods of the common effects, fixed effects and random effects. Results from research hypotheses testing have shown that there is no significant relationship between free cash flows and firm performance. While, there is significant and positive relationship between total asset turnovers with measures of firm performance. Negative and significant relationship is observed between operating income volatility with measures of firm performance.

2.4 Summary of Literature Review

The review has tried to explain various theories that have been put forward to explain the linkage between agency costs and financial performance. Also, empirical review has been conducted to determine the relationship between agency cost and financial performance of firms in different contexts. Largely, there is strong evidence of positive as well as negative relationships between agency cost and financial performance the world over.

2.5 Research Gaps

From the literature review above, a contextual gap has emerged of scarcity of previous studies on the influence of agency cost on financial performance among MFIs in Machakos County in Kenya. In this regard, most of these studies have been done in other contexts but little in the scope of the current study. Conceptually, most studies have examined broad aspects of agency cost in relation to other variables such as performance, profitability and competitiveness among other others.

Therefore, this research gap needs to be addressed by examining the relationship between agency costs and financial performance of microfinance institutions in Machakos County. Essentially, this makes huge empirical contribution to knowledge in this field and particularly MFIs performance in developing countries. In addition, by examining the relationship between these monitoring costs and MFIs, the intervention measures can be further evaluated and improvised by the regulators. The findings can also help the stakeholders and the organizations to better understand the economic rationale for agency costs, and the roles they play in the corporate governance of MFIs.

2.6 Conceptual Framework

In this study, the conceptual framework is based on three independent variables that are presumed to affect finance performance in microfinance banks in Kenya. The dependent and independent variables in Figure 2.1 illustrate the conceptual framework. The framework hypotheses the relationship between the independent and depend variables.

In this case, the figure shows relationship that exists between agency costs and financial performance of firms. Agency costs are operationalized as monitoring costs, bonding costs and residual loss while financial performance is measured by ROI. Return on investment was exclusively used to measure financial performance because MFIs core mandate is deposit-taking and lending hence financial performance can only be determined by ROI. The study relates a set of independent variables which include effect of agency costs on financial performance of MFIs.

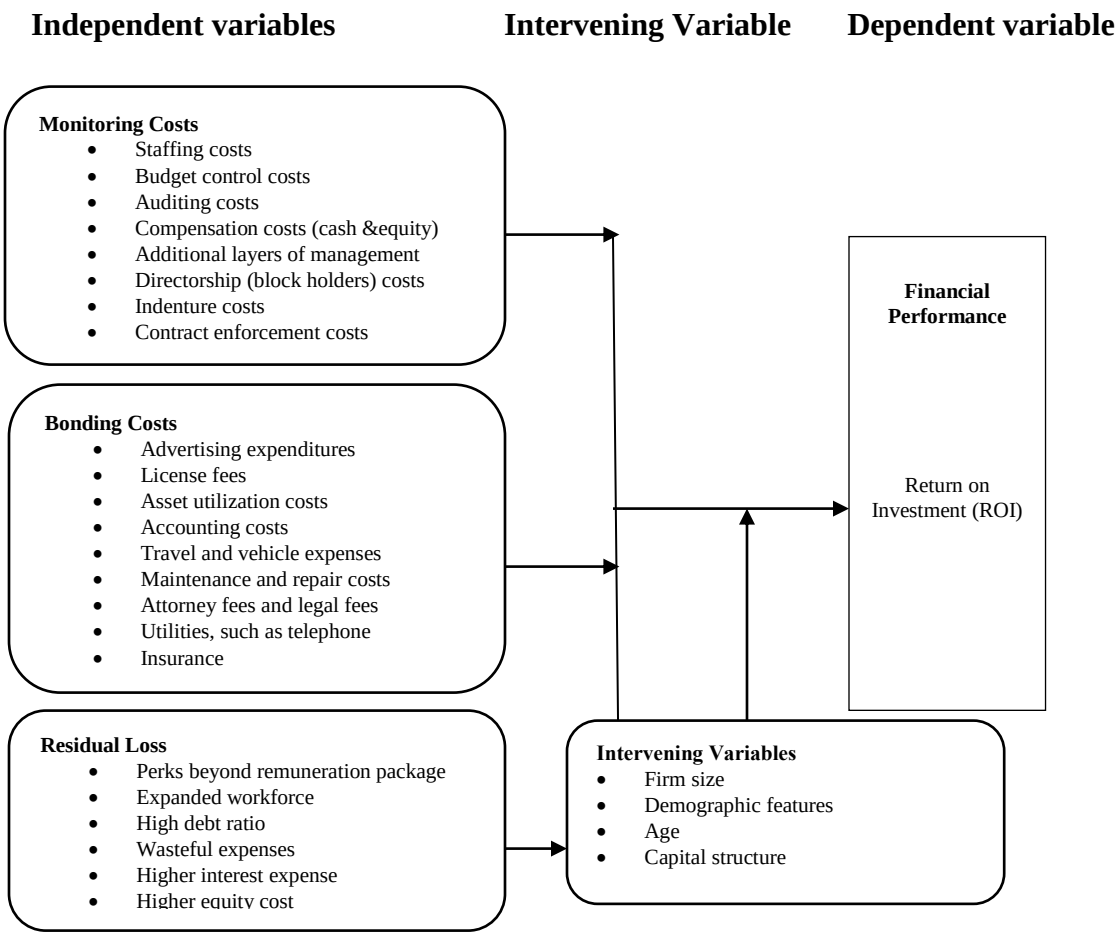

Figure 2.1 Conceptual Framework

Source: Author (2019)

The framework can either show a positive or a negative association depending on how the independent variables behave.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The organized questioning and survey either by hypothesis formation or scientific testing of any enquiry or investigation by following a set of standard rules and procedures is defined as research methodology (Fusch & Ness, 2015). A research methodology defines techniques or tools such as surveys, questionnaires and or interviews adopted in research process to relevant collect, assemble and evaluate data (Stage & Manning, 2015).

Accordingly, this chapter presents the research methodology adopted for the study. It concentrates on identification of the research philosophy that the study adopted, research design, target population, sampling design and procedure, data collection instrument, validity and reliability of the research instrument, data collection procedure, data analysis, and ethical considerations.

3.2 Research Design

This study adopted descriptive research design. Fletcher, Massis and Nordqvist, (2016) argued that, descriptive research design describes the characteristics of a particular group, individual, situation or phenomenon accurately and systematically. A research design is an outline which gives answers to research problems (Fusch & Ness, 2015). It can answer what, when, where, when and how questions, but not why questions.

This research design was an appropriate choice because the research aimed at identifying characteristics, frequencies, trends, correlations, and categories between agency costs and financial performance. Unlike in experimental research, the design was suitable as the researcher was limited in controlling or manipulating any of the variables, but only observed and measured them. Further, it was apt since items in each questionnaire were uniform hence made is easier for analysis and reporting of the findings.

3.3 The Target Population of the Study

For this study, the target population was the three MFIs in Machakos county. Target population also known as the theoretical population, has varying characteristics and it refers to the entire group of individuals or objects to which researchers are interested in generalizing the conclusions Kihn and Ihantola, (2015). The accessible population or study population is the population that is derived from the target population to which the researchers for the smooth conduction of the research and can apply their conclusions. It is from the accessible population that researchers draw their samples (Galvan, 2015).

Although there might have been more MFIs, only three (3) microfinance institutions which included Faulu Microfinance Bank Ltd, Kenya Women Microfinance Bank Ltd and SMEP Microfinance Bank Ltd (CBK, 2017) qualified to for consideration. This is because the present study set a threshold of five years for a MFI to be considered for the study. This was based on the express understanding that a MFI must have been operating for a while to exhibit the effect of agency cost tendencies on financial performance. The accessible population compromised 19 block-holders, 15 board of directors, 2 CEOs and 3 finance directors from all microfinance institutions in Machakos county.

Table 3.1: Target Population

	Category/Strata	**Stratum Population Size**	**Percentage**
1	Block-Holders	19	47
2	Board of Directors	15	37
3	CEOs	3	8
4	Finance Directors	3	8
	Total	**40**	**100**

Source: Author (2019)

Financial data from statement of comprehensive income and statement of financial position was used to calculate the financial performance of the microfinance institutions. These are registered MFIs currently operating in Machakos county, involved in some form of lending and are therefore exposed to agency costs and subsequently affect financial performance. The accessible population provided insightful and relevant information on the relationship between agency cost and financial performance in

Microfinance institutions in Machakos county. The response rate is discussed in the next chapter (chapter four).

3.4 Operationalization and Measurement of Variables

The dependent variable of the study is financial performance, while independent variable is agency costs. From the studies reviewed, 5 or 7 Likert scale point emerged as the dominant variable determination or measurement set-up among studies on partnerships (Marshall & Rossman, 2015). Accordingly, this study adopted 5-point Likert scale in determination of variables of this study.

3.5 Sample Design and Procedure

Essentially, the accessible population comprising only 40 prospective respondents from three MFIs is sufficiently small hence necessitated a census method. It is possible to have more MFIs in the county but only 3 qualified since the study focused on those with over 5 years of operation. In the opinion of Stage and Manning (2015), a census technique of selecting study participants, every single individual or subject of the accessible population is picked to participate in the study.

In other words, it can be referred to as listing or enumerating everyone meaning, which means the whole tally or count. To this end, the study gathered comprehensive or full (complete) data entirely from the accessible population. Therefore, 19 block-holders, 15 board of directors, 3 chief executive officers and 3 finance directors of the three MFIs were selected to take part in the study.

Table 3.2 Census Distribution

	Category/Strata	Stratum Sample Size	Percentage
1	Block-Holders	19	47
2	Board of Directors	15	37
3	CEOs	3	8
4	Finance Directors	3	8
	Total	**40**	**100**

Source: Author (2019)

3.6 Data Collection Instruments

This study used primary data (questionnaires) and secondary data. Primary data obtained from 19 block-holders, 15 board of directors, 3 chief executive officers and 3 finance directors of the three MFIs, was used to determine agency costs (monitoring, bonding and residual costs). Secondary data comprising (detailing) the 2018 MFI supervision annual reports, was obtained from Central Bank of Kenya (2018) with help of secondary data collection sheet detailing which information was required. Financial data from statement of comprehensive income and statement of financial position was used to calculate the financial performance of the microfinance institutions in Machakos County.

The data for the study was not solely obtained from secondary Sources, as some of the information required (such as internal audit costs) was not available from secondary Sources. Primary data was collected using structured questionnaires with questions designed to ensure consistency with the study objectives and research questions. A 5-point Likert scale was used for more expansive responses to capture agency costs such as directors' remuneration, external audit costs, and internal audit costs among others specifically for the financial year ended 2018.

3.7 Data Collection Procedures

The permission to collect data from the organization was sought from the University and also consent from the MFIs was requested by use of a formal introduction letter. Authorization to carry out the research was granted by the National commission for science and innovation. The questionnaire was administered by the researcher and research assistants to ensure accuracy and completeness. Research assistants were trained to minimize data collection flaws and bias (Stage & Manning, 2015). Respondents were given specified ample time to respond to the questionnaire before dropping the same at specified point in the premises. Any issues requiring clarification were adequately addressed promptly by the research team. Adequate requisition for the meeting with the respondents for filling of the questionnaire was done to ensure time saving and non-interference with the respondents' programs. These also ensured the respondents were well prepared and ready the exercise.

3.8 Data Analysis

Primary data on agency costs and secondary data from CBK were used to generate relationship between agency costs and financial performance of MFIs in Machakos County. To achieve this, a multiple correlation and regression analysis was used. This helped to determine the relationship between agency cost and financial performance of micro-finance institutions in Machakos County. Statistical package for social sciences (SPSS), version 23 was also used in data analysis and also to communicate the research findings. Simple regression model was used to test the significance of the independent and dependent variable.

The multiple regression model was as stated below:

$$Y=\beta_O +\beta_1 X_1 +\beta_2 X_2 + \beta_3 X_3 + e$$

Where;

Y = Financial performance of the firm (ROI)

X_1= Monitoring costs of the firm

X_2= Bonding costs of the firm

X_3= Residual loss of the firm

e = error term

β_O= represents regression constant

β_1, β_2, and β_3 = coefficients of regression equation

3.9 Piloting of the Research Instrument

Pilot study is a little trial intended to test coordination and accumulate data preceding a bigger report, so as to improve the instrument's quality and proficiency (Fletcher, Massis and Nordqvist, 2016). It can uncover insufficiencies in the plan of a proposed examination or system and these would then be able to be tended to before creatures, time and assets are exhausted on huge scale ponders (Ravitch & Riggan, 2017).

A pilot is largely about necessary and useful in providing the groundwork in a research project. To pilot test the data–collection procedures, the questionnaire was administered to selected respondents in a neighboring county of Nairobi to validate the content of the questionnaire by adjusting areas deemed inadequate. As a result, required changes were affected before the toll was administered to the respondents.

3.9.1 Validity of Data Collection Instruments

For research questionnaire to meet its purpose, it ought to be reliable and valid. Reliability criterion refers to the internal stability as well as consistency of the instrument. Validity, on the other hand, refers to the extent to which an instrument measures what it is set out to measure. Validity refers not only to what the instrument measures but also to how well it does it. It is whether what one is measuring is what one intended to measure; hence unreliable data is invalid since reliability assures validity (Stage & Manning, 2015).

Validity is the degree to which an assessment measures what it is supposed to measure (Kihn & Ihantola, 2015). The questionnaire was verified for validity of all the possible dimensions of the research topic to ensure it correctly determined or measured the intended measurement, notwithstanding the person responding, the response time and to whom they respond or when self-administered. The validity is greatly influenced by how the instrument is administered and was therefore compared against a gold standard.

The questionnaire was pre-tested the instrument on SMEP micro finance bank Ltd from the neighbouring Nairobi County to determine whether it measured what it was intended to measure. As a result, adjustments were made on the questionnaire items and necessary corrections done. Respondents were asked about the clarity of the questions; the researcher explored the respondent's interpretation of questions to see whether the researcher's meaning was clear. Further, corrections were made to refine the multiple-choice questionnaire items and question sequencing was updated where necessary. This helped to validate the instruments (questionnaires).

3.9.2 Reliability of Data Collection Instruments

Reliability is about stability, consistency and dependability of data; this is when the measurements are not only accurate but also trustworthy, in such a way that somebody else using the same measuring instruments should obtain same or similar results. Simply put, a research tool that is reliable instrument is one, which if constant produces the same outcomes if used with same respondents on different occasions.

Testing of the reliability of the scale is very important as it shows the extent to which a scale produces consistent results if measurements are made repeatedly. This is done by determining the association in between scores obtained from different administrations of the scale. If the association is high, the scale yields consistent results, thus it is reliable. Cronbach's alpha is the most widely used method. It may be mentioned that its value varies from 0 to 1 but, satisfactorily value is required to be more than 0.6 for the scale to be reliable (Marshall & Rossman, 2015).

In the present study, Cronbach's alpha scale was used as a measure of reliability. Specific items in the questionnaire were redesigned to measure the same concept and presented differently in two or more different questions and obtained responses correlated, a manner similar to the equivalent-form technique of reliability testing. Further the researcher carried out a statistical test for reliability using Cronbach's Alpha. To that end a score of 0.76 and above was obtained hence the instrument was deemed reliable as the standard or acceptable threshold is 0.70 and above (Ravitch & Riggan, 2017).

3.10 Ethical Issues

Ethical issues are norms for conduct that distinguish between acceptable and unacceptable behavior during research (Fletcher, Massis & Nordqvist, 2016). The major ethical issues in conducting research include, informed consent, beneficence (do not harm subject), respect for anonymity and confidentiality, and respect for privacy. The researcher adhered to the ethical issues during the study where confidentiality observed and the data that was used only for research purposes.

Respondents were assured that the information they were giving would be confidential and would be used only for academic purposes. Additionally, respondents were assured that information given would not be used to victimize anyone. Besides, any respondent who wanted to withdraw from was allowed to do so. Any information that the researcher obtained in the course of the work was not shared with any other unauthorized persons and other competitors. In addition, the researcher followed the right channels to obtain

any required information without any form of bribery or incentives in exchange for data and information. This was achieved through seeking authorization from the relevant bodies and acquiring the relevant permits to carry out the research.

The researcher dealt only with the authorized and bona fide office bearers for information gathering. Any documents obtained during the study were wholly returned to the MFIs after the research or as agreed upon between the parties. The researcher did not in any way, reproduce, photocopy or print any of the documents obtained without authority and permission from the MFI. The researchers also ensured high levels of integrity during the whole period of conducting the research and ensured confidentiality in information and data collected.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The interpretation and presentation of the study results have been discussed in this section. It presents the response rate, demographic information of the respondents, as well as findings on agency costs, and financial performance. The study results have been presented in accordance with the objectives of the research. Descriptive as well as inferential statistics form the basis for discussion of the study findings.

4.2 Response Rate

A total of 40 respondents constituted the sample size, from whom 30 successfully filled and returned the questionnaires, making a response rate of 75 percent. This response rate sufficed for the researcher to draw reasonable conclusions from the study in accordance with the Mugenda *et al*. (1999) suggestions. The response rate is as shown in Table 4.1 below.

Table 4.1: Response Rate

Category	Frequency	Percentage
Returned	30	75
Unreturned	10	25
Total	**40**	**100**

Source: Author (2019)

4.3 Demographic Information

The respondents were asked to provide the following data: their positions in the current organizations; length of service in current organizations; and length of service in the micro finance sector. Respondents' current organizations were considered valuable because it would demonstrate the relevance of the participants for the nature of the data required. Length of service of the respondents was considered important since it is an indicator of their knowledge of the respective firms, and the micro-finance sector.

4.3.1 Position in Current Organization

The respondents were asked to state their positions in the current organization. The responses were as shown in Table 4.2 below.

Table 4.2: Position in Current Organization

Category	Frequency	Percentage
Chief Executive Officer	3	10
Block-Holders	13	43
Board of Directors	11	37
Finance Directors	3	10
Total	**30**	**100**

Source: Author (2019)

From Figure 4.2, majority of the respondents were block-holders, representing 43% of the respondents; followed by board of directors at 37% while finance directors and chief executive officers; each representing 10% of the respondents. Implicitly, presence of the owners is more felt as block-holders and board of directors outnumber the management (agent). It can be concluded that monitoring costs are most likely more than other costs due to large number of principals in the administration to ensure agents do not make decisions that do not benefit the former.

4.3.2 Length of Service in Current Organization

The respondents were asked to state their length of service in the current organization. The responses were as shown in Table 4.3 below.

Table 4.3: Length of Service

Length of Service	Frequency	Percentage
Below 10 Years	2	7%
10-15 Years	2	8%
16-20 Years	17	55%
21 Years and Above	9	30%
Aggregate	**30**	**100**

Source: Author (2019)

From Table 4.3 above, majority of 55% of the respondents had been in the current organization for a period of between 16 to 20 years cumulatively. 30% of the respondents had been in the current organization for over 21 years. Only 7% of the respondents had been in the current organization for a period of between 0 to 7 years while 8% had been in the current organization for a period between 10 and 15 years. This means that majority of the respondents had sufficient knowledge of the organization, hence would offer useful data on the research question.

4.3.3 Length of Service in Micro Finance Sector

The respondents were asked to state their length of service in the micro finance sector. The respondents were as shown in Table 4.4 below.

Table 4.4: Length of Service in Micro Finance Sector

Number of Branches	Frequency	Percentage
Below 5	2	7%
6-10	2	8%
11-14	6	20%
15 and Above	20	65%
Aggregate	**30**	**100**

Source: Author (2019)

From Table 4.4 above, majority of the respondents had been in the micro finance sector for 15 years and above. About 20% of the respondents had been in the sector for 11 to 14 years. 8% of the respondents had been in the sector for 6 to 10 years while only 7% had below 5 years' experience. This implies that majority of the respondents had been in the micro finance sector for relatively long, hence were capable of providing experienced opinion.

4.4 Descriptive Analysis of Agency Costs and Financial Performance

The study sought to determine the influence of agency costs on financial performance of micro finance institutions in Machakos county. Three dimensions of agency costs were examined, namely: monitoring costs; bonding costs; and residual loss. Data was collected using structured questionnaire, with a 5-point Likert scale. Secondary data was obtained from the annual reports of the individual firms and was processed using a pre-designed format. Return on investment (ROI) was computed from the data obtained from Kenya national bureau of statistics.

The central tendency of the responses was measured using the mean, while dispersion was measured using the standard deviation. The mean measured the extent to which the responses were centered about one point on the scale, while standard deviation measured the degree to which the responses were dispersed from the mean.

4.4.1 Monitoring Costs

The study sought to know from the respondents, on a scale of 1-5, the extent to which various statements relating to monitoring costs were applicable in their organizations. The responses are as shown in Tables 4.5 below.

Table 4.5: Descriptive Statistics on Monitoring Costs

Statements	Mean	Standard Deviation
Staffing costs are high	3.933	0.145
Costs of budget control are high	3.132	0.382
Auditing costs are high	3.146	0.233
Compensation costs (cash & equity) are high	3.337	0.221
Composite Score	**3.387**	**0.245**

Source: Author (2019)

The lowest mean score under the monitoring costs dimension was on the variable of budget control (Mean=3.132, SD=0.382), which was below the composite score of (Mean=3.387, SD=0.245) meaning that this was a relatively adverse opinion. The interpretation is that the expenses or cost spend on budget control was the lowest. This implies the principal's resolve to control the activities of the agent let to better financial performance since the cost was low in other terms, the lower the cost, the higher the financial performance. Simply put, there is a positive relationship between budget control cost and financial performance. Implying budget control activities improves finance performance.

The respondents were asked to rate the extent to which staff costs in their organization was high. Majority of the respondents agreed that that was the case to a great extent (Mean=3.933, SD=0.145). The implication is that there is a negative relationship between staffing costs and finance performance. In other words, this type of monitoring costs is so high that it reduces return on investment hence negatively impacting negatively on financial performance.

The study also sought opinion of respondents on the extent to which auditing costs were high. Majority of respondents indicated a neutral opinion on this issue (Mean=3.146, SD=0.233). The interpretation is that the relationship between auditing costs and finance performance of MFIs is not known hence it is hard to determine if auditing costs influence finance performance positively or negatively. The undecidedness among respondents could be attributed to the secrecy and confidentiality of auditing reports. Secondly, external auditors might have delayed releasing the report by the time this study was carried out.

The respondents were asked to rate the extent to which compensation costs was high. Majority of the respondents were undecided on this issue (Mean=3.337, SD=0.221). The implication is that there is very weak relationship between compensation costs and finance performance of MFIs. As such it is difficult to determine the any strong relations between compensation costs and finance performance of MFIs.

On aggregate, majority of the respondents agreed that their monitoring costs were high to some extent (mean=3.387; SD=0.245). The interpretation is that there is a correlation between monitoring costs and finance performance of MFIs. The implication is that monitoring costs affect financial performance of MFIs negatively thereby ascertaining the research objective this study sought to establish.

4.4.2 Bonding Costs

The second research sought to establish from the respondents, on a scale of 1-5, the extent to which various statements relating to bonding costs were applicable in their organizations. The responses were as shown in Tables 4.6 below;

Table 4.6: Descriptive Statistics on Bonding Costs

Statements	Mean	Standard Deviation
The advertising expenditures high	3.984	0.225
The license fees are high	3.376	0.281
The asset utilization costs are high	3.537	0.332
The accounting costs minimal	3.783	0.215
The travel and vehicle expenses costs are high	3.376	0.281
The maintenance and repair costs are high	3.537	0.332
The attorney fees and legal fees are high	3.784	0.223
Composite Score	**3.632**	**0.279**

Source: Author (2019)

From Table 4.6, the participants were asked to, on a scale of 1-5, rate the extent to which advertising expenditure was high. Majority of the respondents concurred that advertising expenditure was high to a great extent (mean=3.984; SD=0.225). Accordingly, there is a negative relationship between advertising expenditure and finance performance of MFIs

implying advertising expenditure negatively affects finance performance of MFIs in Machakos county.

The participants were further asked to, on a scale of 1-5, rate the extent to which asset utilization costs were high. Majority agreed that their asset utilization was high to a great extent (mean=3.537; SD=0.332). The finding points to a negative relationship between asset utilization costs and finance performance implying asset utilization costs negatively impacts of the financial performance of MFIs in Machakos county.

The participants were also asked to rate, on a scale of 1-5, the extent to which their accounting costs were considered minimal. Majority of the respondents agreed that their accounting costs were considered minimal (mean=3.783; SD=0.215). From this rating, it can be correctly argued that accounting costs do not significantly affect finance performance of MFIs in Machakos county hence there is a weak relationship between the two variables.

The study sought to know from the participants the extent to which their travel and vehicle expenses costs were considered high. Majority of the respondents concurred that their travel and vehicle and expenses were high to a great extent (mean=3.376; SD=0.281). Undeniably, this response confirm existence of strong but negative relationship between travel and vehicle and expenses and financial performance implying travel and vehicle and expenses affect financial performance of MFIs.

The participants were further asked to rate the extent to which their maintenance and repair costs were deemed high. Majority of the respondents concurred that their maintenance and repair costs were high to a great extent (mean=3.537; SD=0.332). This finding implies a strong but negative association between maintenance and repair costs and financial performance of MFIs in Machakos county.

The study sought to know from the respondents the extent to which their attorney fees and legal fees were considered high. Majority of the respondents agreed that attorney fees

and legal fees were high (mean=3.784; SD=0.223). As such, it can be asserted that attorney fees and legal fees has a negative effect on financial performance hence confirming a negative relationship between attorney fees and legal fees and finance performance of the MFIs in Machakos county.

On the aggregate, the respondents agreed that bonding costs were high to great extent (mean=3.632; SD=0.223). The overall or combined rating indicates a strong negative connection between bonding costs and finance performance of MFIs in Machakos county. This conclusion therefore, confirms or ascertains the second objective that sought to determine if there is an association between bonding costs and financial performance among MFIs in Machakos county.

4.4.3 Residual Loss

The final research objective sought to find out from the respondents, on a scale of 1-5, the extent to which various statements relating to residual loss were applicable in their organizations. The responses were as shown in Tables 4.7.

Table 4.7: Descriptive Statistics on Residual Loss

Statements	Mean	Standard Deviation
Perks beyond remuneration package granted to management are high	3.288	0.394
The firm has an expanded workforce	3.537	0.332
The firm has expenses considered wasteful	3.626	0.261
Interest expenses are a concern in The firm	3.750	0.312
Composite Score	**3.494**	**0.316**

Source: Author (2019)

From Table 4.7, the participants were asked to rate on a scale 1-5, the extent to which perks beyond remuneration granted to the management were high. Majority of the

respondents were neutral on the opinion that the perks granted to management beyond remuneration in their organization were high (mean=3.288; SD=0.394). The neutral response shows perks beyond remuneration granted to the management has no significant impact on financial performance hence there is very little association between the two variables.

The participants were further asked to rate on a scale 1-5, the extent to which their firms had expanded work force. Majority of the respondents concurred that their organizations had expanded workforce (mean=3.537; SD=0.332). Having expanded work force is evidence of agency costs implying it impacts negatively on financial performance of MFIs in Machakos county.

The study sought from the respondents to which the extent to which some expenditure in their organizations was considered wasteful. Majority of the respondents agreed that some expenditures in their organizations were considered wasteful to a great extent (mean=3.626; SD=0.261). The interpretation is that there exists a strong correlation between wasteful expenditures and finance performance implying wasteful expenditures affects financial performance of MFIs in Machakos county.

The participants were asked to rate the extent to which interest expenses was a concern in their firms. Majority concurred that interest expenses were a concern in their firms (mean=3.750; SD=0.312). This admission by respondents validates a hypothesized relationship between residue loss and financial performance implying interest expenses eat into firm profitability hence affecting finance performance of MFIs.

On aggregate, the respondents were neutral on the opinion that residual loss was a concern to their organizations (mean=3.494; SD=0.316). Although the aggregate rating points to insignificant association between residual loss and financial performance, it has to be appreciated that out of the four proxies of residual loss, three proxies indicated strong and negative association with financial performance implying majority aspects of this variable influence financial performance significantly.

Overall, the responses above confirm monitoring costs, bonding costs and residual loss affect financial performance of MFIs in Machakos. Therefore, the agent-principal antagonistic relations based on competing interests, takes a strong toll on the financial performance of a firm.

4.4.4 Financial Performance

The study sought to ascertain the relationship between agency costs and the financial performance of the micro finance institutions in Machakos county. Secondary data was obtained from KNBS on return on investment (ROI) for each of the firms, and the distribution was as shown in Table 4.8 below.

Table 4.8: Descriptive Statistics on Financial Performance

Indicator	Mean	Std. Deviation
Return on Investment	0.177	0.019

Source: Author(2019)

From Table 4.8, the firms had mean return on investment of (ROI) 17.7% and standard deviation of 1.9%. This implies that there was minimal dispersion about the mean due to the low standard deviation. This is attributable to the fact that most of firms operate in the same business environment and are subjected to similar macroeconomic factors.

4.5 Correlation Analysis of Agency Costs and Financial Performance

The study sought to determine the correlation between agency costs and financial performance. Correlation is a statistical measure that indicates the extent to which two or more variables fluctuate together. A positive correlation indicates the extent to which those variables increase or decrease in parallel; a negative correlation indicates the extent to which one variable increases as the other decreases. Correlation value of 0 represents no-correlation, absolute values of 1.0-2.5 represent weak correlation, 2.6 to 5.0 represent medium correlation, 5.1 to 7.5 represent strong correlation, and 7.6 to 1.0 represent very strong correlation. The results were as shown in Table 4.9 below.

Table 4.9: Correlation between Agency Costs and Financial Performance

Variable	Monitoring Costs	Bonding Costs	Residual Costs
Financial performance	-0.498	-0.022	0.787**

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Author (2019)

The correlation between monitoring costs, bonding costs, and residual costs each with financial performance was -0.498, -0.022, and +0.787 respectively. Therefore, the most significant correlation was noted between residual costs and financial performance. The implication is that there is a negative relationship between residual loss and financial performance.

4.6 Regression Analysis of Agency Costs and Financial Performance

The study sought to determine the relationship between agency costs and financial performance. Primary data on agency costs was collected using semi-structured questionnaire, while secondary data on return on assets (a measure of financial performance) was obtained from KNBS. Regression analysis was done on the two sets of data. Test for significance of the beta factors was done at 5% level of significance. The results were as shown in Tables 4.10, 4.11, and 4.12.

4.6.1 Monitoring Costs and Financial Performance

The findings in Table 4.10 below show that the value of adjusted R squared was 0.248. This implies that 24.8% financial performance variation could be attributed to the changes in monitoring costs at 5% level of significance.

Table 4.10: Model Summary on Effect of Monitoring Costs on Financial Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	-0.498	0.248	0.236	0.02462

Source: Author (2019)

This shows that 24.8% change in financial performance could be attributed to change in monitoring costs. It is also evident from the findings above that there was a medium negative correlation between the monitoring costs and finance performance as shown by -0.498. From the analysis of variance statistics in Table 4.11, the regression model had a fit with the data ($F=3.814$, $P < 0.05$). This is an indication that monitoring costs had a significant influence on financial performance. There is therefore, a strong correlation between monitoring costs and finance performance of MFIs in Machakos.

Table 4.11: Analysis of Variance of Monitoring Costs and Financial Performance

Model		**Sum of Squares**	**Df**	**Mean Square**	**F**	**Sig.**
1	Regression	1.293	1	0.431	3.814	0.001
	Residual	37.968	29	0.113		
	Total	**39.261**	**30**			

Source: Author (2019)

As shown in table 4.12, the beta coefficient was significant ($\beta = 0.481$, $t = 2.110$, $P < 0.05$). This implies that for every unit increase in monitoring costs there was 48.1% decrease in financial performance. Accordingly, it is undeniable to conclude that monitoring costs negatively affect financial performance of MFIs in Machakos county.

Table 4.12: Model Coefficients on the Relationship between Monitoring Costs and Financial Performance

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.508	1.131		1.333	0.001
	Monitoring Costs	-0.481	0.228	0.203	2.110	0.002

Source: Author (2019)

The below regression equation was established.

$\mathbf{Y = 1.508 - 0.481X_1}$

The regression equation above shows that at constant monitoring costs, performance of an entity would be 1.508. However, a unit change in monitoring costs would decrease financial performance by 48.1%. At 5% level of significance, monitoring costs had statistical significance on financial performance of an entity. The statistics above reveal a strong association between monitoring costs and financial performance of MFIs in Machakos county. The interpretation is that monitoring costs negatively impact on the financial performance of MFIs in Machakos county.

4.6.2 Bonding Costs and Financial Performance

The variation in the output variable as a result of changes in input variable is explained by the adjusted R-Squared. Table 4.13 demonstrates that 60.4% variation in financial performance was explained by changes in bonding costs. The correlation between bonding costs and financial performance was 0.788. This implies that a unit increase in bonding costs would cause 78.8% discrease in financial performance. The implication is that there is a strong relationship between monitoring costs and financial performance of MFIs in Machakos county. The conclusion is that monitoring costs influence financial performance of MFIs in Machakos county thereby validating or confirming the agency-principle controversy or conflict leads to agency costs.

Table 4.13: Model Summary for the Effect of Bonding Costs on Financial Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.788	0.621	0.604	0.06210

Source: Author (2019)

Table 4.14 shows that the model had a significance level of 0.1%. This implies that the model was suitable for drawing a conclusion on the attributes of the population since the p-value was below 5%. It, therefore, shows a relationship between bonding costs and financial performance. As such, it can be concluded that bonding costs significantly influence financial performance of MFIs in Machakos county.

Table 4.14: Analysis of Variance on the Relationship between Bonding Costs and Financial Performance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Residual	2.844	1	0.711	4.903	0.001
	Regression	10.875	29	0.145		
	Total	13.719	30			

Source: Author (2019)

Accordingly, if there were no changes in bonding costs, the organizational finance performance score would be at 1.445. However, a unit increase in bonding costs led to decrease in financial performance by a factor of 0.421. At 5% level of significance, bonding costs were found to significantly influence financial performance. The significance level for the beta factor was 0.2% which was below the 5% threshold. The following equation was, thus, established from the above Table 4.14. $Y = 1.445 + 0.421X_{2.}$ This confirms a strong association between bonding costs and financial performance. Therefore, bonding costs influence financial performance of MFIs in Machakos county.

Table 4.15: Model Coefficients on the Relationship between Bonding Costs and Financial Performance

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	Constant	1.445	0.453		3.190	0.002
	Bonding Costs	0.421	0.145	0.297	2.903	0.003

Source: Author (2019)

4.6.3 Residual Loss and Financial Performance

Table 4.16 shows that the value of adjusted R squared was 0.724. This shows that there was a change of 72.4% on financial performance as a result of variations in residual loss. Therefore, at 5% level of significance, 72.4% change in financial performance was explained by change in residual loss. The value of R was 0.881, implying a strong positive correlation between the residual loss and financial performance.

Table 4.16: Model Summary for Residual Loss and Financial Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.881	0.776	0.724	0.01121

Source: Author (2019)

From Table 4.17 below, the model was found to be robust, with the F value being 4.726, which was less than 2.0196. The p-value was 0.1%, implying that the residual loss was statistically significant at 5% level of significance. The implication is that residue loss impacts negatively financial performance meaning there is a significant correlation between residue loss and financial performance of MFIs in Machakos county.

Table 4.17: Analysis of Variance of Residual Loss and Financial Performance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Residual	2.844	1	0.745	4.726	0.001
	Regression	10.875	29	0.167		
	Total	13.719	30			

Source: Author (2019)

The regression equation below was determined from the above Table 4.17.

$Y = 1.213 + 0.532\ X_3$

The above equation implies that if residual loss were kept constant, financial performance would be 1.213. However, a unit variation in residual loss would cause a corresponding (change) decrease in financial performance by 0.532 factor. Tellingly, there is a significant association between residue loss and financial performance of MFIs in Machakos county.

Table 4.18: Model Coefficients on Residual Loss and Financial Performance

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	Constant	1.213	0.453		3.190	0.002
	Residual Loss	0.532	0.197	0.014	2.701	0.005

Source: Author (2019)

From Table 4.18, if there were no changes in residual loss, financial performance would be at 1.213. However, a unit (change) increase in residual loss would lead to a decrease in financial performance by 53.2%. Residual loss was found to significantly influence financial performance, at 5% level of significance. The implication is that residue loss significantly influences financial performance of MFIs in Machakos county.

4.6.4 Monitoring Costs, Bonding Costs, Residual Loss, and Financial Performance

The study sought to determine the joint effect of monitoring costs, bonding costs, and residual loss on financial performance. Multiple regression model was used to meet this objective and the results were as shown in Tables 4.19, 4.20, and 4.21.

Table 4.19: Model Summary on Monitoring Costs, Bonding Costs, Residual Loss and Financial Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.808	0.653	0. 633	0.69440

Source: Author (2019)

Table 4.19 shows that the adjusted R squared was 0.633. This demonstrates that there was a change of 63.3% in financial performance as a result of the changes in monitoring costs, bonding costs, and residual loss at 5% level of significance. This was a demonstration that 63.3% changes in competitive advantage could be explained by joint effect of monitoring costs, bonding costs, and residual loss. Table 4.20 presents the analysis of variance from the model.

Table 4.20: Analysis of Variance on Monitoring Costs, Bonding Costs, Residual Loss, and Financial Performance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	0.813	3	0.271	3.045	.021
	Residual	2.759	27	0.089		
	Total	3.572	30			

Source: Author (2019)

From the analysis of variance statistics in Table 4.20 above, the data had significance of 2.1%, an indication that the data was suitable for conclusion drawn on the parameters of the study population. The F critical at 5% level of significance was 2.0196. Since the F calculated (3.045) was above the F critical, the overall model was found to be significant. This is an indication that monitoring costs, bonding costs, and residual loss significantly

influenced financial performance. Table 4.21 presents the model coefficients for the joint effect of monitoring costs, bonding costs, and residual loss on financial performance.

Table 4.21: Model Coefficients on Monitoring Costs, Bonding Costs, Residual Loss, and Financial Performance

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
Constant	1.298	0.453		2.865	0.006
Monitoring Costs	-0.237	0.160	0.198	2.479	0.012
Bonding Costs	0.231	0.126	0.245	3.834	0.001
Residual Loss	0.239	0.145	0.008	2.065	0.023

$p<0.05$, dependent variable; organizational performance

Source: Author (2019)

The below regression equation was established from Table 4.21 above.

$$\mathbf{Y = 1.298 - 0.237X_1 + 0.231X_2 + 0.239X_3}$$

Therefore, if monitoring costs, bonding costs, and residual loss were each kept constant, financial performance would be 1.298. However, at 5% level of significance, a unit change in monitroing costs would lead to decrease in financial performance by a factor of 0.237; unit increase in bonding costs would lead to increase in financial performance by a factor of 0.231, while a unit change in residual loss would lead to increase in financial performance by 0.239.

To that end, monitoring costs, bonding costs, and residual loss have significant relationship with financial performance. In the present study, these agency costs have a negative impact on the performance of MFIs in Machakos county. This study validates the main theme of this study that agency cost influences financial performance and this cost could also affect firms in different proportions.

4.7 Discussion of Findings

The objective of the research was to establish the influence of agency costs on financial performance of microfinance institutions in Machakos county. The findings of the study were then compared with prior empirical evidence. In the current study, agency costs were operationalized as monitoring, bonding and residual loss. Basically, these were the key research constructs the study sought to establish in relation to financial performance of MFIs in Machakos county.

As such, the first objective sought to establish the relationship between monitoring costs and financial performance among MFIs in Machakos county. Monitoring costs variable was operationalized as staffing costs, additional layers of management, directorship (block holders), budget control, auditing costs and compensation costs.

From the findings in this thematic area, monitoring costs such as staffing costs, additional layers of management and directorship (block holders) costs were rated as high spenders. The monitoring proxy of budget control costs was the lowest was found to have spent the least funds. The auditing costs and compensation costs received neutral or undecided. On aggregate, majority of the respondents agreed that their monitoring costs were high. The interpretation is that there is a correlation between monitoring costs and finance performance of MFIs. The implication is that monitoring costs affect financial performance of MFIs negatively thereby ascertaining the research objective this study sought to establish.

This finding is consistent as well as inconsistent with numerous previous studies. For instance, Quayes (2015) agrees with the current study that staffing costs, additional layers of management affect organization performance. Ahmed, Bhuiyan, Ibrahim, Said and Salleh (2016), are in agreement with this finding when they established that firms from overseas record higher agency related costs due to policy of these firms to employ highly qualified to do best auditing because the principals are far.

This view is shared by Bortych's (2017) who found out, MFIs hire high-end quality auditing officers which increases monitoring costs. Understandably, reports with more details emanate from more aspects or items to be audited requiring more auditing input in terms of time and human effort. As a result, auditors charge more fees for such massive work culminating in increased agency costs.

The second objective aimed at establishing the link between bonding costs and financial performance of MFIs in Machakos county. Bonding costs was operationalized in terms of advertising expenditures, license fees, and asset utilization costs, accounting costs, travel and vehicle expenses, maintenance and repair costs as well as attorney fees and legal fees. All proxies or types of bonding costs were rated as very high. On the aggregate, the respondents agreed that bonding costs were high to great extent. The overall or combined rating indicates a strong negative connection between bonding costs and finance performance of MFIs in Machakos county. This conclusion therefore, confirms or ascertains the second objective that sought to determine if there is an association between bonding costs and financial performance among MFIs in Machakos county.

Various previous studies are in agreement while others are otherwise on this finding. Amaoko and Goh (2015) maintain that firms with excess cash flow have high agency costs the agency costs are high. Managers invest the excess free cash flow in projects which are non-value maximizing. Equally, Abdulrahman (2014) observed there exist a relationship between agency costs and financial performance. Likewise, Acharya, Dupatti, and Locke (2015) found out that agency costs have a strong association with performance. Similarly, Adabenege and Yahaya (2015) concurred with the findings of the current study by arguing that agency costs have a significant relationship with financial performance.

In their study conducted in the UK, Ahmed, Bhuiyan, Ibrahim, Said and Salleh (2016) established that block-holders (concentrated type of ownership) equally scales down agency costs. However, Bortych (2017) established that the concentrated form of

company ownership has been found not to lower agency costs in Indonesia but a company that is family owned, puts agency costs in check.

Additionally, D'Espallier, Goedecke, Hudon and Mersland (2017) revealed zero agency cost among companies where the owner doubles as the manager because this structure ensures the alignment of both the owners and managers' interests. Proponents of agency theory hold the view that agency costs are considerably lowered by effective governance. Moreover, the researchers determined that big as well as influential boards of directors offer very effective governance. On the other hand, Mishkin (2016) companies are properly governed by lesser or boards with less directors. Nurmakhanova, Kretzschmar and Fedhila (2015) associated less agency cost with a board consisting more directors but Randoy, Strom and Mersland (2015) established the contrary in the sense that the less the directors of a board the less the agency costs.

On the other hand, Casselman, Sama and Stefanidis (2015) observed reduced agency costs are attributed to a board that is independent. Furthermore, Kiaritha (2015) concurred with a study carried by Wangai, Bosire and Gathogo, (2014) also investigated whether use of debt in capital structure can minimize the conflict between managers and shareholders.

The final objective set out to establish the relationship between residual loss and financial performance. This research variable was operationalized in terms of perks beyond remuneration package, expanded workforce, high debt ratio, wasteful expenses and higher interest expense. Neutral Residual loss or costs such as perks beyond remuneration package, expanded workforce, high debt ratio, wasteful expenses and higher interest expense.

On aggregate, the respondents were neutral on the opinion that residual loss was a concern to their organizations. Although the aggregate rating points to insignificant association between residual loss and financial performance, it has to be appreciated that out of the five proxies of residual loss, three proxies indicated strong and negative

association with financial performance implying majority aspects of this variable negatively influence financial performance significantly.

Equally, different previous studies are in agreement as well as disagreement to the role of residual loss on finance performance of firms. Further Kleynjans and Hudon (2016) established relationship between free cash flow and agency costs. Performance of a company was operationalized as ROA and ROE. They established that residual loss did not affect the financial performance of firms.

Consequently, Hoepner, Liu, Sandberg and Wilson (2017) had findings in consistent with agency theory's assumptions that asserts the duality of a CEO does not lead to high returns. However, Banerjee, Karlan and Zinman (2015) observed the reverse and suggested more inquiry into influence of board structure on returns. Elsewhere, Wijesiri, Yaron and Meoli (2017) found a strong positive correlation between family-owned and managed companies' agency costs and performance. Aribi and Arun (2015) observed a free cash flow increases agency cost. Alabdullah (2016) reported a positive connection between agency cost and an organization's profitability.

Further,Ayuma, Namusonge and Iravo (2015) established an agency relations between higher institutions of learning and the government are direct and are expressed in form of policy, parliamentary legislation, establishment, financing higher education, collaboration and research. Similarly, Biwott, Asienga, Oketch and Mutai (2015) established that agency cost as well as some determinants of managerial behavior had influence on firm performance.

Overall, the responses above confirm monitoring costs, bonding costs and residual loss affect financial performance of MFIs in Machakos. Therefore, the agent-principal antagonistic relations based on competing interests, takes a strong toll on the financial performance of a firm. Finally, correlation and regression solidified the findings above. It is also evident from the findings above that there was a medium negative correlation between the monitoring costs and finance performance.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

In this chapter, summary of the study results, conclusions as well as recommendations have been presented in accordance with the objectives of the research. The summary, conclusion and recommendations have been made in accordance with the objectives, methodological approach, findings, and limitations of the current study.

5.2 Summary of Findings

The study sought to determine the relationship between agency costs and financial performance. Primary data on agency costs was collected using semi-structured questionnaire, while secondary data on return on assets (a measure of financial performance) was obtained from the individual firms' annual reports. Regression analysis was done on the two sets of data. Test for significance of the beta factors was done at 5% level of significance.

5.2.1 Monitoring Costs and Financial Performance

The first objective was to determine the influence of monitoring costs on financial performance of MFIs in Machakos County. The study determined that 24.8% change in financial performance could be attributed to change in monitoring costs. It is also evident from the findings above that there was a medium negative correlation between the variables as shown by -0.498. The regression model had a fit with the data ($F=3.814$, $P < 0.05$). This is an indication that monitoring costs had a significant influence on financial performance at 5% level of significance since the p-value was 0.1%, which was below 5%.

5.2.2 Bonding Costs and Financial Performance

The second objective of the study was to establish the effect of bonding costs on financial performance in MFIs in Machakos county. It was determined that if there were no changes in bonding costs, the finacial performance score would be at 1.445. However, a unit change in bonding costs led to increase in financial performance by a factor of 0.421.

At 5% level of significance, bonding costs were found to significantly influence financial performance. The significance level for the beta factor was 0.2% which was below the 5% threshold.

5.2.3 Residual Loss and Financial Performance

The third objective of the study was to determine the effect of residual loss on financial performance of MFIs in Machakos County. It was found that the value of adjusted R squared was 0.724. This shows that there was a change of 72.4% on financial performance as a result of variations in residual loss. Therefore, at 5% level of significance, 72.4% change in financial performance was explained by change in residual loss. The value of R was 0.881, implying a strong positive correlation between the residual loss and financial performance.

5.3 Conclusion

The study had three specific objectives, which each objective pursued through hypothesis testing. Data on independent variables was collected using structured questionaire while data on dependent variable was obtained from the financial records of the firm. Test of significance was done at 95 degree of confidence (5% level of significance) through examination of the actual p-vales. P-values equal to or greater than 0.05 implied non-significance, otherwise it was deemed to be signifiicant.

The first objective was to examine the influence of monitoring costs on financial performance of MFIs in Machakos County. The study determined that monitoring costs were in deed statistically significant influencers of financial perfromance of an MFI. This could due to the prevention of misappropriation of funds by the management and staff due to the stringent monitoring systems.

The second objective of the study was to establish the effect of bonding costs on financial performance in MFIs in Machakos county. It was determined that bonding costs influenced financial performance. This can be attributed to the enhanced interpersonal

interactions, sharing, and knowledge of the various human resource challenges. This can reduce pressures and burn outs that may lead to cheating by staff.

The third objective of the study was to determine the effect of residual loss on financial performance of MFIs in Machakos County. It was found that residual loss statistically significantly influenced financial performancce. This could be due to the decrease in finances for expansion that could lead to expansion in future profitability, and hence financal performnce.

5.4 Recommendations

The study recommends that the academics in the field of strategic management should consider using the empirical evidence adduced to further their research interests. Theorists should also consider the findings of this study to find further empirical foundation in light of the linkages between corporate governance, ownership structure, and organizational performance. By so doing, further studies in other contexts, including public, private, manufacturing, and service will come up.

The study further recommends the findings for the development of policies that would be geared towards sustainability of the microfinance firms in Kenya. The Ministry of Finance and other relevant government agencies in Kenya should apply the study findings in decision making since it would assist in developing well-informed policies geared towards the achievement of the Vision 2030, the Big Four agenda, and the sustainable development goals in Kenya.

Finally, the study recommends that the top management team of the respective microfinance institutions in the survey should use the findings for guidance and planning in making necessary reforms to their respective MFIs to enhance their positive financial performance for the benefit of the shareholders returns. Specifically, because the study findings has drawn important lessons for success and best practices for the microfinance sector, sustainability against the backdrop of increased competition from the mobile telephone based electronic lending platforms such as Tala, Fuliza among others in Kenya.

5.5 Limitations

A few limitations were encountered in this study. Some respondents were uncooperative in filling the questionnaires; this limitation was mitigated by invoking a conversation with the respondent's first to make them at ease. This strategy was used also to reduce the risk of the respondents giving socially-correct responses. Some respondents were also reluctant to share the MFIs information with the researchers but this was mitigated by signing of confidentiality forms at the MFIs by the researchers.

Some respondents also took longer than expected time to fully complete the questionnaire; the researcher however ensured questionnaire submission was done early enough to allow significant time for completion. Early preparation of questionnaires and pre-testing of the same also helped the researcher time for analysis and presentation. The study only obtained data from the three MFIs in Machakos county that might not be true representation of MFIs in Kenya. Machakos county is also one of the 47 counties in Kenya and each county by itself has its own social -economic challenges thus making comparisons a challenge.

This study also used only three proxies of agency costs, whereas there are other possible agency cost surrogates which the study did not factor in. This study is based on the findings and analysis of 2017 annual financial reports, thus interpretations deviating from the findings of this research may occur if the period is outside the study period, or when a different research methodology is implemented

5.6 Recommendations for Further Research

This research focused on limited areas and suggestions for further research are as follows:

i. The current study focused on agency costs. Other researchers may consider investigating other variables in corporate governance such as board structure, board competence, board composition, and board remuneration. This is because the findings of the current study are limited to the agency costs as a dimension of corporate governance.

ii. Since the current study focused on financial performance, future studies may consider investigating non-financial dimensions of corporate performance. This sis because in this age, preoccupation with profitability is not a sustainable way of doing business. Other performance dimensions such as customer focus, learning and growth, and business process are also important.

iii. The current study focused on Machakos county, Kenya. Other researchers may consider focusing on the examining the same phenomenon in other counties in Kenya especially the more rural counties, including Taita Taveta, Garissa, and Baringo. This is because Machakos county is unique in terms of its social and economic composition, hence the findings of the study may not apply to other contexts.

iv. The current study used cross sectional survey design. Longitudinal surveys are often more powerful in determination of cause-effect relationships, but are also more expensive and time consuming (Kothari, 2004). Other researchers may consider examining the same phenomenon using longitudinal survey design. Others may also consider using case study designs to undertake more in-depth study of the same phenomenon in one MFI since surveys often lack this power.

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