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Effects of financial risks on the financial performance of listed firms in Nairobi securities exchange, Kenya

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Abstract

Over the years decline of financial risk management is growing as a complex task. Financial managers are looking for ways to minimize risk for any organization but their complexity falls increasingly in the world of economic events. The general objective of the study was to assess the effect of financial risks on the financial performance of listed firms in Nairobi Securities Exchange Kenya. The specific objectives of the study included: to assess the effect of liquidity risks on the financial performance of listed firms in Nairobi securities exchange Kenya, and to examine the effect of credit risks rating on the financial performance of listed firms in Nairobi securities exchanges Kenya. This study adopted a descriptive survey research design. The target population for this study comprised of all 66 listed companies in Kenya. Census sampling techniques was used to arrive at the sample size of 66 listed companies, in order to collect data required. Secondary data was collected using document review such as audited financial reports and financial journals. Data analysis was done using descriptive statistics. The researcher used descriptive statistical method of mean, standard deviation, percentages and frequencies to understand the characteristics of the variables. The study adopted correlation and regression analysis to establish the relationship between financial risk and financial performance of listed firms in Nairobi Stock Exchange. The analyzed data was presented in tables and graphs. Ethical issues were taken into consideration by maintaining high level confidentiality of the data collected. The findings revealed that liquidity risk has a significant effect on financial performance of listed companies in Nairobi Securities Exchange. Secondly, credit risk has a significant effect on financial performance of listed firms in Kenya. Further confirms that interest rate risk has a significant effect on financial performance of listed firms and debt management risk has a significant effect on financial performance of listed firms. In conclusion all firms involved in business would often times engage in credit lending to their clients and firms with borrowed funds are often financially distressed by the rise in interest rates and those intending to borrow are restricted to the covenants of the lenders. Finally debt management in an internal firm issue that is dependent on the management boards' decision. It is recommended that firms' liquidity rate risk should be monitored at all times to ensure that liquidity is maintained at appropriate levels. Also credit rate risk should be clearly stated in the firms credit policy and measures put in place to review it depending on the circumstances.

Key words: *Financial Risks; Financial Performance; Firms; Nairobi Securities Exchange; Kenya*

1.0 Introduction

Over the years decline of financial risk management is growing as a complex task. Financial managers are looking for ways to minimize risk for any organization but their complexity falls increasingly in the world of economic events. Studies on the developing countries indicate the need for change in policies in financial risk management (Okelo, 2015). Jomo and Rock, (2003) describes financial risk in different positions of Asia and Africa in the global economy. The view is explains the need of different levels of financial risk faced by each continent, and points out risks associated with financial globalization as high exposing to volatile external forces.

Financial risk measures the additional risk that the firm's stockholders bear when the firm is financed with debt as well as equity. Globally, financial risk is a major concern and there are numerous studies to support the need to investigate it. Breen and Lerner argued in the context of decision making that variations in financial and operational decisions could

change the stock returns and may enhance the uncertainty regarding investment (Lane 2003) addresses the financial crisis in Europe and U.S.A and points heightened financial risks as the major cause of decline. Tamborini, Trautwein & Mazzocchi, (2014) point out that the main concern of the Global Risk Network is systemic to financial risk, that it is the most immediate from the economic point of view.

Jomo and Rock, (2003) financial risk is of different positions in Asia and Africa in the global economy explaining the different levels of financial risk faced by each continent, and pointing out that risks associated with financial globalization are high, exposing fragile economies to highly volatile external forces.

1.1 Statement of the Problem

Listed firms have been experiencing poor financial performance. Managing financial risk is a major challenge to financial managers. This has been evidenced by the study of Sitati & Odipo, (2011) who observed that listed firms operates at unproductive profit level due to high financial risks resulting poor financial performance. Olweny et al., (2013) found that liquidity risk is critical to survival of business firms, but poor financial performance is caused by high financial risk. Further Okelo, (2015) examined financial risk management and growth of firms in Uganda. The finding indicated that financial risk is an essential aspect of the firms in terms of credit risk management. This indicates that poor credit risk management constrains the firm operations and customers are not satisfied with services provided signifying poor financial performance leading to retardation in the firm's growth. Despite, this study will seek to assess the effects of financial risk on the performance of firms listed in the NSE.

1.2 Objectives of the stud:

i) To assess the effect of liquidity risks on the financial performance of listed firms in Nairobi securities exchange Kenya.
ii) To examine the effect of credit risks on the financial performance of listed firms in Nairobi securities exchanges Kenya.

2.0 Literature Review

This theory is important in the influence of other economic theories that deal with investment and finance. The theory was started by Hary Markowitz in portfolio selection in1952. Theory hypothesized that it is not adequate to come across expected risk and return of specific stock. The investor takes risk through investing more in the market other than one stock. This theory is adopted in this study because investors can collect more benefits by diversification between firms. The reduction of riskiness finance in any portfolio must be quantified. Theory is used to quantify financial benefits by diversification. It is known not putt all the business stock in one market it is better to diversify by variety.

For listed firms is stock exchange are like other investors who take risk by buying more stock in return may be lower than they expected in normal markets. In other financial risk, there is need to deviate from the use of average return. Every stock is standardized by use of Market Portofolio risk. The risk in this listed firms are expressed in form of portfolio from various firms stocks. The risk expected is less than financial risk intrinsic to hold any individual firm stocks in provision of risks expected from various firm stocks which is not openly associated.

The portfolio theory hold two risky firms stocks in which one must pays off and another may not pay off when there is no flow of stocks. The theory of portfolio contains in cooperation of return on assets which always must be paid off to the regardless of whether there is no sales. The theory is applied to financial risky to understand how return on asset influence another to the return of equity to reduce overall financial risk of all business portfolio in that concentration risk to the creditors (Richardson, 2002).

2.1 Empirical literature review

2.1.1 Liquidity Risk and financial performance

Ilhomovich, (2009) conducted a study of factors affecting the performance of foreign banks in Malaysia. The aim of the study was to investigate the effect of liquidly management and financial performance. The study was conducted in banking firms operation in Malaysia and later submitted for fulfilment of Master of Science in banking. The study findings show that degree of financial leverage is used to measure level of leverage. Accessibility of financial information acts as a determinant of financial risk that has been identified in prudential supervision. The

study shown by Sangmi, (2010) identified models used to explain financial risk and financial performance.

Salami and Iddirisu (2011) analyzes the effect of factors affecting financial performance of commercial Banks in India. The study had objective to investigate the application of liquidity model Pakistan commercial banks. The study used descriptive statistics and correlations to analyze the data. The study employed correlations to show the existing relationship between financial performance and liquidity risks. The study further indicated that ownership concentration in liquidity is the determinants of financial risks. Liquidity risks arise from financial situations in which a party interested party trade in the asset ration which cannot do it because nobody in the market wants to trade for that asset.

Chung, 2014) conducted the study on the effect of Liquidity risk in the financial performance of listed company Uganda stock exchange. The study aim was to investigate the impact of credit risk and market risks on financial performance of listed companies in Uganda. The study adopted a survey design approach. The study employed regression and inferential statistics to analyze collected data. The study revealed that currently hold of asset affects ability of business, manifestation of liquidity risk is different from price decrease. The decrease in asset price to zero affects performance. The study further shows that the market is of return on asset are worthless. However, one business party cannot vary with that interested trade in the asset. The study findings indicated that this one can potentially affect market participants to find profit of each other. This is the reason as to why liquidity risk is usually higher in the emerging markets due to low sales volume of markets. The risk-averse to investors is naturally requiring advanced liquidity risk control. The liquidity risk is adjusted in form of capital adequacy in pricing model, thus states that, higher liquidity risk, the higher required return on assets in the listed Uganda stock exchange.

Osoro Cliff and Ogeto Willy (2014) examined external determinants of banks profitability and its implications in risk management practices in Kenya. The study aim was to examine the effect of microeconomic fluctuations on financial performance of listed firms in manufacturing sectors. The study targeted 22 firms. The study used regression analysis and time series data between the periods of 2001 to 2006. The finding indicated that measures of risk determinants of firm's on profitability were employed as it indicated by liquidity, credit and capital adequacy, GDP growth rate; interest rate risks and inflation rate risk were used as external determinants of banks profitability. The findings also indicated that composite index of firm's profitability. The study used return on asset (ROA) as an indicator of firm's financial performance. Findings show that liquidity and credit risk have negative impact on firm's profitability.

Mugenda Galo and Momany Gideon (2012) studied the implication of risk management practices on financial performance of firms in Kenya. The study was conducted for the award of master of Chuka University College. The focused on the effect of the implication of risk management practices on financial performance of firms in Kenya. The respondents were reached through survey design and exploratory approach. Then study used research questionnaire and interview schedules. Then correlation coefficient was employed to determine the relationship between risk management practices and financial performance in Sugar Company. The finding shows that decision making, effective management prevents possibility of firms' failures.

2.1.2 Credit Risk and Financial performance

Mwangi (2012) did a study on the effect of credit risk management practices on the financial performance of commercial banks in Kenya. The objectives of this study were to analyze the credit risk management practices undertaken by Commercial Banks in Kenya. The study was to determine and assess the effect of these risk management practices on their financial performance. Secondary data was also collected on the financial performance of the banks from the annual reports and audited financial statements. From the findings indicated that risk management is significantly related to financial performance of commercial banks. Credit risk is influenced by guidelines from Central Bank of Kenya and also the nature of the banking industry. In most cases banks had adopted a proactive and

enterprise approach to manage risk practices in risk department in a documented risk management policy. This was communicated throughout all levels of organizations. The study found that risk management practices have significant effect on financial performance. The study found that the integration of risk management is set as the key risk practices on financial performance.

Sharma and Gounder, (2012) conducted a study on the effect of risk management on Dairy farming performance. The study was conducted in Norway. The study was a journal of risk management. The study aim was to examine the effect of credit risk in the financial performance. The study used description design. Research questionnaire was used as the research instruments. The study used regression analysis to establish the relationship between credit risk and financial performance. The findings show that the risk of default, debt may arise from borrower failing to make payments. However, the finding indicated that risk comes from lender who includes lost of principal interest, cash flows and costs. Credit default risk is from a debtor who refuses to pay its credit obligations in full or more than 90 days earlier period due in any material credit obligation; default risk affect credit sensitive to transactions, including loans through lending's securities and financial derivatives.

Yakup and Asli, (2010) studied on the effect of market credit risks and financial institutions. The study objective was to examine the effect of credit transaction and financial performance. The study used empirical study to establish the results. The use of factor analysis was done. The study results show that counterparties risk take credit risk insurance otherwise chiefly on financial derivative. The study require posting of collateral to improve financial performance. However the studies do not indicate methods of data analysis, data collection and testing hypothesis. Findings show that credit risk is not always possible because of liquidity issues are used for longer term systemic reasons. Credit risk is increasing due to absolutely connected risk factors.

3.0 Research methodology

The descriptive design was used because it was appropriate as the study sought to assess the effect of financial risks on financial performance of firms listed in the NSE. The population of the study was all firms listed in Nairobi Securities Exchange, Kenya.

4.0 Results and findings

4.1 Introduction

This chapter presents descriptive analysis of the data employed in each objective. The chapter presents regression analysis and interpretation of the result.

4.2 Descriptive Statistics

The study analyzed 40 firms listed in Nairobi Securities Exchanges in Kenya from 2011 to the end of 2015. The data was collected from published financial statements of each sector and annual reports from Nairobi Securities Exchanges record. The study used panel data with 40 firms with a period 5 years. The collected data was put into excel packages and then transferred to SPSS version 21 for analysis.

4.2.1 Liquidity risk on financial performance

The study sought to establish the effect of Liquidity risk on financial performance of listed firms in Nairobi Stock exchange.

Table 4.1 Liquidity risk on financial performance of listed firms in Nairobi Stock exchange

	N	Min	Max	Mean	Std. Deviation
Agriculture	5	4.12	10.32	6.8205	2.38156
Automobile	5	.19	1.15	.7780	.35592
Commercial services	5	1.26	1.67	1.5047	.16548
Construction	5	1.35	1.70	1.5427	.17730
Energy and petroleum	5	.96	1.35	1.1913	.14643
Manufacturing	5	1.29	1.67	1.4170	.15649
Valid N (listwise)	5				

Source: Field data (2018)

The results shows that Agriculture had high liquidity risk at a mean of 6.8205 with standard deviation of 2.38156 which was followed by Construction sector with a mean of 1.5427 with standard deviation of 0.17730, Commercial services with a mean of 1.5047 with a standard deviation of 0.16548, Energy and petroleum sectors had a mean of 1.1913 with a standard deviation of 0.14643 and lastly Manufacturing sector 1.4170 with a standard deviation of 0.15649. The study indicated that agriculture had a minimum

liquidity of 4.12 and maximum 10.32. However, Automobile sectors had the lowest statistical mean at 0.7780 with a standard deviation of 0.35592. This implies that agriculture sector had created more money from their operations which are sufficient to meet liquidity obligations, despite financial performance with automobile sectors which suggested more concentration on liquidity improvement.

4.2.2 Credit risk on the financial performance

The sought to examine the effects of credit risk on the financial performance of listed firms in Nairobi Stock exchanges in Kenya.

Table 4.2 Descriptive Statistics of Credit risk on the financial performance

	N	Min	Max	Mean	Std. Deviation
Agriculture	5	.26	.30	.2840	.01657
Automobile	5	.47	.64	.5560	.06599
Commercial services	5	.43	.60		.06775
Construction	5	.48	.54	.5107	.02140
Energy and Petroleum	5	.63	.73	.6701	.03770
Manufacturing	5	.44	.57	.5097	.05274
Valid N (listwise)	5				

Source: Field data (2018)

The study showed that Energy and Petroleum had a mean of 0.6701; Automobile had a mean of 0.5560, Construction 0. 5107, Manufacturing had a mean of 0. .5097, Commercial services had a mean of 0. 4867 and Agriculture had a mean of 0.2840. The standard deviation has low divergent value which is an indication that listed firms have more financial risks among themselves in improving financial performance. The study showed that Energy and Petroleum had the high level of credit risk in financial performance during the period. However, Agriculture had the lowest statistical mean of 0.2840 and indication of low credit risks. The maximum and minimum values are 26 and 73 respectively implies that listed firms concentrates on credit risks than other financial risks to improve performance. The study also showed that how far agriculture sectors employed credit activity is not prone to more financial risks.

4.3 Regression Analysis

The research study sought to investigate the relationship between financial risk and financial performance of listed firms at the NSE in relation to various variables. The variables investigated were; Liquidity Risk, and Credit risk, The regression model was; $Y= \beta_0 +\beta_1 X_1 + \beta_2 X_2$ where as the Y represents Financial Performance measured by return on assets, X_1- Liquidity risk, X_2- Credit risk, ε is the regression model's error of estimate from the calculated results. β_1, β_2 β_3 and β_4 represent regression coefficients.

Table 4.8 Model Summary

Model	R	R Square[b]	Adjusted R Square	Std. Error of the Estimate
1	1.000[a]	.999	.996	2.2275402

a. Predictors: Liquidity Risk, Credit risk
b. For regression through the origin (the no-intercept model), R Square measures the proportion of the variability in the dependent variable about the origin explained by regression.
Source: Field data (2018)

Table 4.8 shows that there is good linear relationship between the independent and dependent variables employed in the study. This is indicated by regression coefficient of 1.000. The coefficient of determination was measured by R Square[b] presents a strong statistical relationship between the independent variables (Liquidity Risk, Credit risk,) and dependent variables (ROA) with a value of .999. This implies that financial risk accounts for 99.6% of the variations in financial performance of listed firms at the Nairobi securities exchange, while the residual 0.4 percentage is influenced by other variables.

Table 4.9 ANOVA

Model		Sum of Squares	Mean Square	F	Sig.
1	Regression	5600.098	1400.024	282.153	.045[c]
	Residual	4.962	4.962		
	Total	5605.060[d]			

a. Dependent Variable: Financial performance(ROA)
b. Linear Regression through the Origin
c. Predictors: Liquidity Risk, Credit risk,
d. This total sum of squares is not corrected for the constant because the constant is zero for regression through the origin.
Source: Field data (2018)

Analysis of Variance statistics consists of calculations that provide information about variability in the regression model and test of significance levels. The finding shows that the significance value is 0.045 not greater than 5%, hence the model is statistically significant in predicting how financial risk affects financial performance of listed firms in Nairobi security exchange.

The F critical value at significance level 0.05 was 282.153. Thus, the calculated F value is 282. 153 greater than the F critical this indicates that overall model is significant. From the Analysis of Variance statistics shows that the population parameters had a significance level of 5% which indicates that the data collected is perfect to make conclusion on the p-value 0.45 less than 0.05. F critical value at 5% level of significance is 282.153, because the calculated F is more than critical value. This implies that the overall model is significant and that Liquidity Risk, Credit risk is significantly affecting financial performance of listed firms at Nairobi security exchange in Kenya.

Table 4.10 Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	Liquidity Risk	4.275	3.784	-.296	-1.130	.021
	Credit risk	79.122	23.104	1.052	3.425	.011

a. Dependent Variable: Financial performance(ROA)
b. Linear Regression through the Origin

Source: Field data (2018)

Table 4.10 shows the established regression equation as $Y= -4.275X_1 + 79.122X_2$, X_1- Liquidity risk, X_2- Credit risk. From the equation it is indicated that unit increase in Liquidity risk would result to a decrease to return on assets of listed firms by 4.275, unit increase in credit risk would results to increase in return on assets of listed firms by 79.122. The findings indicated that there is a negative relationship between liquidity risk and financial performance of listed firms at Nairobi security exchange. The study further revealed that there is a positive relationship between Credit risk, and financial performance of listed firms at Nairobi security exchange in Kenya.

5.0 Conclusion and remmendations

5.1 Conclusion

Liquidity levels are critical to the survival of any entity and need to be maintained at some minimum levels. A creditor with a claim may subject a firm to be declared bankrupt in the event of low liquidity levels. However management may argue that maintaining high liquidity levels is equivalent to having idle cash at the company coffers the converse position is even work as the company risks liquidation.

Secondly credit rates are governed by the company policy which varies from one company to the other. All firms involved in business would often times engage in credit lending to their clients. While this is argued as a way of increasing the volume of trade it has been misused by customers to leap off companies. It is imperative on the management of these companies to strike a balance between increasing volume of business and too much lending which may translate to bad debts.

5.2 Recommendations

Firms' liquidity rate risk should be monitored at all times to ensure that liquidity is maintained at appropriate levels. This will ensure that any short term claim on the firm can be offset within the shortest time possible. This will also encourage more investors by shaping investor perception about the firm. Credit rate risk should be cleared stated in the firms' credit policy and measures put in place to review it depending on the circumstances. This will ensure that the policy is more realistic to the firms' main objectives. In

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