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Financial Management Practices On Profitability Of An Organisation: A Case Of Smartline Matatu Service Limited, Kenya

[1]Makori Onkware, [2]Dr. Daniel Makori, [3]Dr. Abel G. Anyieni
[1,2,3]*School of Business, Kenyatta University,. P.O Box 21677-00100 GPO, Nairobi, Kenya.*

Abstract: Financial management practice is vital for the sustainability of large and small investments. However the financial management practices on the profitability of the Matatu industry have not been fully investigated. This study will assess financial management practices on Profitability of Smartline matatu service limited Kenya. The significance of the study is to create awareness to investors, of the financial management practices that would better the trade, add to the existing knowledge and help the government in policy formulation. The target population was based on 30 respondents comprising the shareholders of Smartline Service Limited and 5 Managers of the company. The researcher adopted a census method where all the 25 shareholders and 5 Managers of Smartline Limited were involved in the study. This study used the questionnaire as a tool in the collection of primary data. Data was analyzed using descriptive statistics, correlation, factor analysis and regression. From the findings the researcher concluded that banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline. Interest rates charged by banks to those affiliated with Smartline are lower than rates charged to unaffiliated investors. Concerning the effect of agency decision on profitability the researcher concluded that, Matatu owners have a very strong incentive to monitor the operations of Smartline Services Limited management. Matatu owners (investors) provide proper incentives to Smartline management services limited so that they in turn concentrate on maximizing the wealth for the owners. In the light of the foregoing findings, the study recommends that in-order to enhance firm performance the management of Matatus ought to consider all the financial Management practices affecting their business either positively or negatively. The study also recommended that government should scrap all the unnecessary payments in the matatu industry this will reduce the operation cost in the industry. The matatu industry should source for finances as a group this will help them to enjoy all the advantages of group borrowing offered by majority of financial institutions. The researcher recommended that further studies should be done on; financial Management practices on profitability of Matatu businesses in Nakuru County.

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I. Introduction

Profitability is the ability of a business to earn excess of what is left of the revenue a business generates after it pays all expenses directly related to the generation of the revenue, such expenses as related to the conduct of the business' activities which may include the cost of capital in terms of interest, the cost of operations like fuel, wear and tear, statutory expenses and salaries. The attaining and maintenance of profitability by most companies and individuals that have invested in this sector has been very elusive either due to rush decisions made without adhering to financial decisions principles or ineptitude prompted by agency problem which has caused the giants like the Nyayo bus service and Akamba to wind up (Abdullatif, 1990). Yet financial management practice on profitability of matatu agencies such as Smartline Matatu Services Limited is yet to be established).

The selection of investment in *matatu* industry is a huge capital project which involves acquiring of assets which entails heavy amount of funding.

General Objective the study to assess financial management practices on profitability of Smartline Matatu Service Limited Kenya. Modern portfolio theory (MPT) proposes how decision to invest in assets or securities under risk. It is based in the assumption that investors are risk-averse (Pandey, 2001). This implies that investors hold well-diversified portfolio instead of investing their entire wealth in a single asset or security. Modern portfolio theory proposes how rational investors will use diversification to optimize their portfolio and how a risky asset should be priced.

Copeland, Shastri and Weston (2005) suggest the use of CAPM for determining the cost of a security weighted average cost of capital, in capital budgeting and valuation of securities. The CAPM is a single-factor

model that specifies risk as a function of only one factor, the security's beta coefficient (Brigham &Daves, 2004). Markowitz (1959) laid the foundation of MPT the greatest contribution of which is the establishment of a formal risk/return framework for investment decision making. While investors typically do not view those returns above the minimum they must earn in order to achieve their investment objectives.

Agency theory (Jensen &Meckling, 1976; Fama& Jensen, 1992; Fama, 1980) states that agency costs arise from the conflict of interest between a principal and an agent. Agency theory divides the costs of such arrangements into structuring costs, monitoring costs, and costs of bonding a set of contracts. Costly control procedures, such as the use of contracts, are necessary to align the actions of the managers (the agent) with those of the residual claimants, the shareholders (the principals). Agency theory stresses that such means of contracting reduce agency costs by coordinating the goals of the principal and the agent. It has been recognized that the separation of ownership and control in the modern. Corporation results in potential conflicts between owners and managers (Horne &Wachowicz, 2001). The objectives of managers may differ from those of the firm's shareholders. Thus, this separation of ownership from management creates a situation in which management may act in its own best interest rather than those of the shareholders

Kothari and Shanken (1997) measured beta with annual returns to avoid trading problems and found substantial compensation for beta risk. They suggested that the results obtained by Fama and French (1992) may have been time period-specific and might not be significant over a longer period. Pettangall, Dundaram and Mathrur (1995) noted that empirical studies typically used realized returns to test the CAPM model when theory specifies expected returns. Pettangall, Dundaram and Mathrur (1995) adjusted for negative market excess returns they found a consistent and significant relationship between beta and rates of return. Jagannathan and Wang (1996) employed a conditional CAPM that allows for changes in betas and in the market risk premium this model performed well in explaining the cross section of returns. Grundy and Malkiel (1996) also contend that beta is a very useful measure of risk during declining markets which is when it is most important. Much later when Reilly and Wright (2004) examined the risk adjusted performance for 31 different asset classes utilizing betas computed using a very broad proxy for the market portfolio the risk-return relationship was significant and as expected in theory.

The financing or capital structure decision is a significant managerial decision, that influences the shareholders return and risk, consequently, the market value of the share may be affected by the capital structure decision. The investor will have to plan its capital structure firm initially at the time of its promotion. Subsequently, whenever funds have to be raised to finance investments an involved (Brigham &Ehrhardt, 2008). Oira (2015) on his study on the problem of urban transport in Kenya in relation to government regulation access to finance, the upshot of cartels unprofitability of the industry concluded that these variables particularly the cost of operations affect the profit of the company adversely. Ndiwa (2014) concluded that capital structure of sugar manufacturing industries in Kenya had a negative on financial performance on return on capital employed and strongly recommended that the sugar firms deceased from the use of long term capital in order render positive returns.

Emery, Finnety and Stowe (2007) conducted a study to investigate debt-equity ratio in the private corporate sector in India, he tested the relation of debt equity ratio with age, total asset, retained earnings, profitability and capital intensity. He found that age, retained earnings and profitability were negatively correlated while total assets and capital intensity was positively related to debt-equity ratio. Pandey's (1999) study about the corporate managers attitude towards use of borrowing in India revealed that the practicing managers generally preferred to borrow instead of using other sources of funds because of low cost of debt due to the interest tax deductibility. Pandey (2001) conducted another empirical study examining the industrial patterns, trends and volatilities of leverage and the impact of size, profitability and growth on leverage. Sharpe (2007) studied the impact of size, growth, business risk, dividend policy, profitability, debt service capacity and the degree of operating leverage on the leverage ratio of the firm. A number of studies have been done relating to financing and agency decisions but none has directly explored the performance of capital structure, cost of capital, and cost of operation and agency decisions on profitability of *matatu*. Therefore this study is aimed at establishing the performance of financial management factors on profitability with regard to capital structure, cost of capital, cost of operation and agency decisions on returns with a case of Smartline service limited in Nakuru County.

II. Research Methodology

Israel (1992) argues that a census is attractive for small populations. The target population was based on 35 respondents comprising the shareholders and Managers of the company. The researcher adopted a census method where all the 25 shareholders and 5 Managers of Smartline Limited were involved in the study. Primary data was collected by use of semi-structured questionnaires,(Kothari, 2004). A pilot study was done to testing the reliability of the instrument and establishes the validity of the instruments for the research. Secondary data for the study was collected from Smartline office records.

This study used questionnaires for collection of primary data, where both structured and unstructured questions were used to capture more information. The multiple linear regressions were used to establish the relationship between the cumulative effects of various independent variables on the dependent variable. The multiple regression models separate each individual variable from the rest allowing each to have its own coefficient describing its relationship to the dependent variable

$\gamma = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \varepsilon$,

where,

γ = Profitability of Smartline Service Limited, β_i = Coefficient, x_1 = Cost of capital

x_2 = Cost of operations, x_3 = Capital structure, x_4 = Agency decisions, ε = Error Term

3.2 Respondents' Highest Level of Education

The respondents were asked to indicate their highest level of education. The findings were as shown in Table 4.2.

Table 3.1: Respondents' Highest Level of Education

	Frequency	**Percentage**
Primary	2	8%
Secondary	3	12%
Tertiary	11	42%
Graduate	8	30%
Postgraduate	2	8%
Total	**26**	**100**

From the findings, 8% of the respondents indicated that they had attained primary education, 12% indicated that they had attained secondary education, 42% indicated that they had tertiary education, 30% of the respondents stated they had attained graduate while 8% stated they had attained postgraduate. This shows that majority of the respondents had attained tertiary education.

3.2 Duration of service

The respondents were asked to indicate the duration they had been working in the organization. The findings we as presented in Table 4.3.

Table 3.2. Duration of service

Years	**Frequency**	**Percentage**
Less than 1 Years	1	4%
1-5 Years	5	19%
6-10 Years	6	23%
More than 10 Years	13	50%
Total	**26**	**100**

According to the findings, 4% of the respondents indicated that they had been working with the organization for less than 1 years, 19% stated they had been working with the organization for 1-5 years, 23% stated they had been working with organization for 6-10 years while 50% stated they had been working with organization for more than 10 years. This shows that majority of the respondents had been working with organization for less than 1 years.

3.4 Descriptive Statistics

The study requested respondents to give opinions in regard the impact of cost of capital, cost of operations, capital structure and agency decisions on profitability Smartline Service Limited.

3.5 Cost of capital on profitability of Smartline Service Limited.

The respondents were asked to indicate their level of agreement on the effect of cost of capital on profitability of Smartline Service Limited.

Table 3.1: Cost of capitalon profitability of Smartline Service Limited.

	SA	A	NS	D	SD	Mean	Std
Taxation is reduced when one uses own capital than loans.	16(62)	7(27)	3(11)	0 (0)	0 (0)	4.500	0.432
Banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline	6 (23)	7(27)	8(31)	5 (19)	0 (0)	3.923	0.431

Interest rates charged by banks to those affiliated with Smartline&are lower than rates charged to unaffiliated investors	9 (35)	11(43)	2 (7)	4 (15)	0 (0)	3.962	0.393
Through SmartlineServices Limited, we areable to build relations with the lenders hence reducing the cost of borrowing.	7 (27)	14 (54)	2 (7)	3 (12)	0 (0)	3.962	0.412
Because the number of passengers change depending on the season, yet banks require to be repaid regularly and promptly, servicing the loan can be very difficult	11(43)	10 (38)	1(4)	4 (15)	0 (0)	4.077	0.445
The demand for transportation service can guarantee a steady supply of money enough to take care of the bank loan repayment	10(38)	13 (51)	1 (4)	2 (7)	0 (0)	4.192	0.432
The obligation to pay back owners and lenders does not hinder the smooth running of Smartline.	5 (19)	7 (27)	4 (16)	8 (31)	2 (7)	3.192	0.342

According to the findings, the respondents strongly agreed that taxation is reduced when one uses own capital than loans with a mean of 4.500. They also indicated with a mean of 3.923 that banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline. They further indicated with a mean of 3.962 that interest rates charged by banks to those affiliated with Smartline are lower than rates charged to unaffiliated investors. In addition, the respondents indicated with a mean of 3.962 that through SmartlineServices limited, owners are able to build relations with the lenders hence reducing the cost of borrowing.

They further indicated with a mean of 4.077 that interest rates because the number of passengers' changes depending on the season, yet banks require to be repaid regularly and promptly, servicing the loan can be very difficult. They also indicated with a mean of 4.192 that demand for transportation service can guarantee a steady supply of money enough to take care of the bank loan repayment. Finally, the respondents indicated with a mean of 3.192 that the obligation to pay back owners and lenders does not hinder the smooth running of Smartline.

This implies that borrowing as a company is efficient in terms of interest rates, mode and duration of payments, this ensure steady supply of money and consequentially affect the performance of the company. The findings are in line with Iturriaga and Sanz, (2001) who found out that an increase in the tax rates on the other hand would lead to an increase in the cost of capital. Thus, it will narrow the gap between the profits and the input costs translating to higher cost of capital (Keown et. al., 2005).

Extent to which various operations cost affects profitability of Smartline Service Limited

The respondents were asked to indicate the extent to which various cost of operation affect profitability of Smartline Service Limited.

Table 3.2: Extent to which various operation cost affect profitability of Smartline Service Limited

	VGE	GE	ME	LE	VLE	Mean	Std
Fuel cost	15(58)	5(19)	2(8)	4 (15)	0 (0)	4.192	0.374
Tyres and Spare Parts cost	9 (35)	7(27)	2(8)	8 (30)	0 (0)	3.654	0.387
Insurance cost	8 (30)	7 (27)	2 (8)	9 (35)	0 (0)	3.539	0.365
Bank loan and interest rates	11 (42)	10 (39)	2 (7)	3 (12)	0 (0)	4.115	0.385
Labor cost	7 (27)	9 (35)	4 (15)	6 (23)	0 (0)	3.654	0.398
Maintenance cost	9 (35)	11 (42)	1 (4)	5 (19)	0 (0)	3.923	0.374
Distance traveled	5 (19)	7 (27)	3 (12)	11 (42)	0 (0)	3.239	0.398
Police inspections	9 (35)	10 (38)	3 (12)	4 (15)	0 (0)	3.923	0.424
Payments to Government Agencies e.g. Kenya venue Authority, council	8 (31)	7 (27)	3 (11)	8 (31)	0 (0)	3.885	0.324
Sacco registration costs	3 (11)	4 (15)	5 (19)	10 (39)	4 (15)	2.692	0.423

According to the findings, the respondents indicated with a mean of 4.192 that fuel cost affect the profitability of SmartLine Services Limited to a very great extent. The respondents further indicated with a mean of 3.654 that tyres and spare parts cost affect the profitability of SmartLine Services Limited to a very great extent. Also, they indicated with a mean of 3.539 that insurance cost affects the profitability of SmartLine Services Limited to a very great extent.

Further they indicated with a mean of 4.115 that that bank loan and interest rates affect the profitability of SmartLine Services Limited to a very great extent. The respondents further indicated with a mean of 3.654

that labour affect the profitability of Smart Line Services Limited to a very great extent. Further they indicated with a mean of 3.923 that maintenance cost affects the profitability of SmartLine Services Limited to a very great extent. The respondents further indicated with a mean of 3.239 that distance travelled affect the profitability of SmartLine Services Limited to a very great extent. Also, they indicated with a mean of 3.923 that police inspections affect the profitability of SmartLine Services Limited to a very great extent. Further they indicated with a mean of 3.885 that Payments to Government Agencies e.g. Kenya Revenue Authority, council affect the profitability of SmartLine Services Limited to a very great extent finally with a mean of 2.692 that Sacco registration costs affect the profitability of SmartLine Services Limited to a low extent. The costs of operation are the readily available amounts of money that runs the day to day activities of a business venture (Mak, and Kusnadi, 2005).

Effect of capital structure on profitability of smartline

The respondents were asked to indicate their level of agreement on the effect of capital structure on profitability of Smartline Service Limited.

Table 3.3: Effect of capital structure on profitability of Smartline

	SA	A	NS	D	SD	Mean	Std
Owner contributed capital is the best Way to finance matatu business	14(54)	10(39)	2 (7)	0 (0)	0 (0)	4.462	0.387
Banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline	7 (27)	8(31)	5(19)	6 (23)	0 (0)	3.615	0.465
To grow the business, the first choice of funds will be bank loans	6 (23)	7(27)	3 (11)	10(39)	0 (0)	3.346	0.384
To invest in Matatus personal vehicles provide an asset to secure a loan	7 (27)	6 (23)	3 (12)	8 (31)	2 (7)	3.154	0.378
The use of borrowed capital affect the profit of the company positively	14(54)	10(39)	0(0)	2 (7)	0 (0)	4.385	0.432
The tax reduction on interest expense of loan capital is the incentive to the use of debt capital	11(43)	13 50)	0 (0)	2 (7)	0 (0)	4.269	0.432
The decision to borrow capital for the business is out of impulse than a financial consideration	6 (23)	8 (32)	2 (7)	10(38)	0 (0)	3.385	0.345
The obligation to pay back owners and Lenders does not hinder the smooth running of business.	3 (11)	5 (19)	4 (15)	11(44)	3 (11)	2.769	0.432

According to the findings, the respondents agreed that Owner contributed capital is the best Way to finance matatu business with a mean of 4.462. They also indicated with a mean of 3.615 that banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline. They further indicated with a mean of 3.346 that to grow the business, the first choice of funds will be bank loans. In addition, the respondents indicated with a mean of 3.154 that inorder to invest in Matatus personal vehicles provide an asset to secure a loan. They further indicated with a mean of 4.385 that the use of borrowed capital affects the profit of the company positively.

They also indicated with a mean of 4.269 that tax reduction on interest expense of loan capital is the incentive to the use of debt capital. They also indicated with a mean of 3.385 that the decision to borrow capital for the business is out of impulse than a financial consideration. Finally, the respondents indicated with a mean of 2.769 that the obligation to pay back owners and Lenders does not hinder the smooth running of business. Studies have shown that use of debt in increasing the capital to cater for the investments only exposes the business to future problems in the coming investments(Omran and Pointon, 2004; Mollah, 2011; Rose, 2005).

3.5. Regression Analysis

The study evaluated how the change management under study (cost of capital, cost of operations, Capital structure and agency decisions) influence organization profitability at Smartline Service Limited. Using multiple regression analysis and Analysis of Variance (ANOVA), the combined effect of cost of capital, cost of operations, and capital structure and agency decisions on organization profitability at Smartline Service Limited was established.

Table 3.6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.725[a]	.525	.498	.67974

a. Predictors: (Constant), Cost of Capital, Cost of Operations, Capital Structure and Agency Decisions

As indicated in Table 4.14 the adjusted coefficient of determination ($r^2 = 0.525$) shows that 52.5% organization profitability could be explained by cost of capital, cost of operations, capital structure and agency decisions at Smartline Service Limited. The 50.2% of organization performance resulted from other factors.

Table 3.7: Analysis of Variance (ANOVA[b])

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	35.773	4	8.943	19.356	.000[a]
	Residual	32.343	70	.462		
	Total	68.116	74			

a. Predictors: (Constant), cost of capital, cost of operations, capital structure and agency decisions

b. Dependent Variable: Organization Profitability

According to the ANOVA results the association between the financial management practices under study (Cost of Capital, Cost of Operations, Capital Structure and Agency Decisions) and organization profitability was positive and significant as indicated by the F calculated ($F = 19.356$; $P < 0.05$).

Table 3.7: Significant Test Results for Overall Model

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.335	.366		3.651	.001
	Cost of Capital	.030	.112	.026	.266	.791
	Cost of Operation	.323	.106	.360	3.052	.003
	Capital Structure	.333	.109	.377	3.057	.003
	Agency Decision	.140	.091	.137	1.547	.126

a. Dependent Variable: Organization Profitability

Table shows the overall significant test results for the hypothesized research model.
The interpretations of the findings indicated follow the following regression model.

$$\mathbf{Y= \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \mathcal{E}}$$

Therefore,

$$\mathbf{Y= 1.335 + 0.030 X_1 + 0.0323 X_2 + 0.333 X_3 + 0.140 X_4}$$

It was noted that financial management investigated in the study significantly influenced organization profitability ($t = 3.651$; $p < 0.05$). It was further noted that the influence of cost of capital and agency decision was not significant ($p > 0.05$). However cost of operation and capital structure significantly influenced organization profitability. In addition, it is noted that holding (cost of capital, cost of operation, capital structure and agency decision) constant, organization profitability would be 1.335. This would be as a result of other factors not investigated in the study. Out of the four factors investigated, cost of operation and capital structure were the most important since to generate one unit of organization profitability, 0.323 units of cost of operation and 0.333 units of capital structure must be increased. Therefore Smartline Service Limited ought to focus more on cost of operation capital structure in their organization.

III. Conclusions

Of the seven costs of capital factors among the respondents, willingness by the banks to lend and charge lower rates to member of the Sacco was strongly agreed at 33.3percent and 35.5 percent respectively. However demand for transportation as steady supply of money enough to take care of the bank loan repayment was reported was the least strongly agreed at 6.3 percent as a factor establishing the performance and cost of capital on profitability of the Sacco.The second objective was to examine the performance of cost of operations on profitability of Smartline Service Limited, in Nakuru County. The study found out there are various costs of operations of Sacco business this include fixed costs and variable costs. The study found out that each and every business picks a capital structure that would provide the greatest appeal to the shareholders and the investors and would later lead to lowering the cost of capital while maximizing the value of the company in the presence of the efficient investment strategies laid down by the management of the business.

The study found out that trade-off between the use of debt and equity in the financial considerations of investments is crucial in the determination of the capital structure used. Agency decisions on Profitability ensure that the company does not run into losses since they are the ones who manage the company. In the study the role of the owners of the business is to ensure that capital is pumped in and oversee the day to day operations of the business and ensure that the managers use their money correctly and efficiently. Owners serve to protect their shares in the company so that the business does not cease to exist**.**

The study concluded that banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline. Interest rates charged by banks to those affiliated with Smartline and are lower than rates charged to unaffiliated investors. The demand for transportation service can guarantee a steady supply of money enough to take care of the bank loan repayment. When the tax rates of the products the business deals in are reduced by a notable amount, it follows closely that the amount of money spent on the inputs of the business will go down leading to an increase in the profit margin if the selling price or the operation costs were to remain the same. An increase in the tax rates on the other hand would lead to an increase in the cost of capital. Thus, it will narrow the gap between the profits and the input costs translating to higher cost of capital.

The interest rates are factored in the cost of capital mainly when the company utilizes the current liabilities and the long term debts in financing its operations. Therefore, an increase in the interest rates on the loans of the company would lead to an extra cost in the expenditure of the company. This increment would be detrimental to the goals of the company when it comes to the achievement of the profits targeted. A decrease in the interest rates levied on the loans secured by a business would avail more amount of money to be included in the running of the business hence more profit as in the case of the study.

The cost of fuel is a two-way factor on the profit realization in this business venture. When the cost of fuel hikes, the company is faced with the decision to make on whether to hike the transport costs as well or to suffer the change and get less profit. If the cost of fuel drops down, the company will definitely get more profit as the charge leveraged on the customers often remain constant. In the study most of the respondent agreed to a greater extents over 70 percent that the fuel cost was an important

The researcher further concluded that banks are more willing to lend to Smartline members than to those who are not affiliated to Smartline. The obligation to pay back owners and Lenders does not hinder the smooth running of business. Studies have shown that use of debt in increasing the capital to cater for the investments only exposes the business to future problems in the coming investments. With time the loans will grow in size and lead the business to a den it will not be able to come back from to its initial stable state. However, use of equity is contemplated with the use of debts in the situations where the investment is not tax-deductible. Thus the size of the equity or the debts determines and plays a great role in determining the capital structure of a business.

Concerning the effect of agency decision on profitability the researcher concluded that, Matatu owners have a very strong incentive to monitor the operations of Smartline Services Limited management. Matatu owners (investors) provide proper incentives to Smartline management services limited so that they in turn concentrate on maximizing the wealth for the owners. The management of Smartline Services limited views the long- term survival of the organization as more important than their own personal gain. Monitoring costs play a role in ensuring efficient operation and maintenance of the properties of the company to secure future profits and promise smooth operation of the day to day activities. Thus proper monitoring ensures increased profitability. Other Investments by the company would serve as a backup plan for the business in dire times of need or financial bailout when the main venture fails to pay its bills.

In-order to enhance firm performance the management of Matatu Saccos ought to consider all the financial factors affecting their business either positively or negatively. A clear understanding of all the financial obligations will positively improve their profitability.

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