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The Effect of Short-Term Debt on Profitability among Deposit-Taking Microfinance Institutions. A Critical Literature Review

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Jane Njeri Kinyua

Finstock College, School of Finance

Corresponding author's email: journals@carijournals.org

Abstract

Purpose: Very few deposit-taking microfinances institutions are profitable. Most of them report loses in every financial year. The making of the losses may be a result of inefficiency in short term debts. The overall objective of this study was to examine influence of equity financing on the growth of micro, small and medium enterprises.

Methodology: The paper used a desk study review methodology where relevant empirical literature was reviewed to identify main themes and to extract knowledge gaps.

Findings: From the findings of the study, the study concludes that short term debt had a positive and significant association on the profitability of the deposit-taking microfinance. The study also concludes that short term debt has a positive and significant relationship on the profitability of the deposit-taking microfinance. This means that profitability would increase with a proportionate increase in in the level of the short-term debt when all other factors affecting the profitability of the organizations are held constant. The study showed that when the company borrows, availability of sufficient funds to finance the available assets of the company, which in return improves in the level of performance.

Unique Contribution to Theory, Policy and Practice: Based on the coefficients of determination, the study recommends that policymakers in the microfinance institutions should use short term debt for the financing of the activities. The cost of the short-term debts is minimal and generally offers lower interest charges, and most lenders do not charge interest until all credit allowance period is breached and therefore becomes useful for companies.

Keywords: *Effect Short Term Debt, Profitability, Deposit-Taking, Microfinance Institutions*.

INTRODUCTION

Microfinance is very critical in the poverty eradication in many states of the World. They are widely known to target the poor and the marginalized groups by use of innovative approaches such as joint lending, progressive lending and regular payment (Wijesiri & Meoli, 2015). The general concept of the microfinance institutions can be traced down from early 1700s through the work of an Irishman, Jonathan Swift, who facilitated the creation of a bank to the poor in rural areas in Ireland (Rade, 2016). In Canada and United States, the microfinance organizations mostly target the less fortunate and marginalized populations who are not in a position to access to the commercial banks and a close of eight percent of the Americans are not banked (Nyaga, 2017).

Financial leverage describes the companies' business structure and reveals the equilibrium between two long term finance sources (Andrew, 2015). When the firms borrow, the difference between directors and creditors increases the control costs, so the firms disclose more information to convince the shareholders and creditors to decrease the control costs (Chesang, 2017). Adams and Ferreira (2016) discovered that large firms have the tendencies of disclosing their information to their shareholders contrasted with the little firms. Most likely it will comprehend the potential favorable circumstances of information exposure, for example, more prominent attractiveness and more prominent simplicity of financing. Smaller companies may feel that full data revelation may jeopardize their focused position (Barako, Hancock & Izan, 2016).

However, Bhuiyan and Roudaki (2018) found no relationship between the estimated leverage, evaluated as obligation/book estimation of value and the proportion of Corporate social responsibility (CSR) introduction. Leverage was proposed as significant to clarifying varieties in the degree of corporate financial exposure. Alsaeed (2016) contended that organizations with relatively more substantial measures of obligation in their capital structure are slanted to higher office costs. The financial leverage includes: short term debts, long term debts and equity ratio (Watts & Zimmerman, 2018; Harvey & Puri, 2017; Adams & Ferreira, 2016).

Short term debt financing has a maturity time of one year or less and should be repaid within four months. Further, the short-term loans have a low-interest rate and the companies prefer it when looking forward to having short term financing (Yazdanfar & Öhman, 2015). Additionally, according to Mian and Santos (2018), the short-term debts help to address the quick issue for financing without long term responsibility. The cost of changing short term obligation is less load on the association. Short term advances generally offer lower interest charges, and most loan lenders do not charge interest until all credit remittance period is over (Kahl, Shivdasani & Wang, 2015). Money related choices of transient obligations and liabilities are basic since they set up the money related relentlessness of the firm in the market (Godswill, Ailemen & Osabohien, 2018).

The profitability of microfinance institutions in Kenya has been dwindling over time (Gweji & Karanja 2014). According to Cherotich, Sang, Mutungú and Shisia (2015), the profitability is the difference between the revenue generated and the total cost and expenses used. The profitability determines the survival and the extent to which the organization is capable of advancing to modern technology (Siddik, Kabiraj & Joghee, 2017). The profitability of microfinance institutions is influenced by both internal and external factors (Kiplangat, 2017). The organization has control over internal factors while in the external factors; the company has no control over (Kariu, 2017). The profitability measures include returns on assets (ROA), return on equity (ROE), and profit margin. ROA is a financial ratio that shows the percentage of profit a company earns concerning its overall resources and it is defined as net income divided by total assets of a firm (Muriu, 2016).

ROE measures how well a company uses its equity to generate profits for the shareholders (Sharma, 2018). It is calculated by dividing the net profits with total equity. Lastly, the profit margin is calculated by dividing the net profits by total sales (Muriungi, 2014). Some of the scholars such as Hussein (2018), Kariu (2017), King' ori, Kioko and Shikumo, (2017) and Matthews (2017) established that ROA is better to measure profitability and forecast trends in market structure. Hence, the study adopted Return on Assets to measure profitability. The justification of using ROA as a measure of profitability was because other scholars used the same indicator to measure profitability. Some of these scholars include Abubakar 2015, Siddik, Kabiraj and Joghee, 2017, Godswill, Ailemen and Osabohien (2018), Muthuri (2018), Wambua (2018), Maura and Oketch (201), Mwai (2018) Amsi, Ngare, Imo and Gachie (2017). ROA measures the efficiency of using assets to generate profit. The financial leverage is all about managing debts to acquire additional assets and thus, it was essential to examine the efficiency of assets acquired. Therefore, ROA was ideal was a significant indicator of measuring profitability in the current stiudy.

Short term debt has been found by various scholars and researchers to affect profitability. Aro and Pennanen (2017) found that firms can make use of short-term financing, which may affect the profitability depending on the cost of the source of the funding. Bendavid, Herer and Yücesan (2017) observed that firms might have a specific ration of short-term liabilities if its financing structure they feel is optimum in enhancing performance and profitability. Dombret, Gündüz and Rocholl (2019) observed that firms which had high short term debt levels when compared to their long term debt performed better than their competitors Kumar and Kaushal (2017) established that the use of short-term liabilities such as trade payables and accruals could have a positive effect to the productivity of the organizations since such sources of financing may be less costly to the business than the longer-term sources of funds. Further, short term sources of funds may have a positive influence on profitability due to the reduced contractual engagements that are involved. Furthermore, Nawaz and Ayele (2015) claimed that the short maturity of short-term debt might be expensive to the firm hence increasing its cost of capital. It is against this background that the study intended to examine the effect of short-term debt on profitability among deposit-taking microfinance institutions**.** A Critical Literature Review

Statement of the Problem

The profitability of the microfinance institutions in Kenya increases their sustainability and capability in providing financial services to low-income earners (Kathomi, Kimani & Kariuki, 2017). However, most of these microfinance institutions make losses, making their sustainability in jeopardy, Ochieng (2018) found that very few Deposit Taking Microfinance Institutions are profitable due to financial constraints. Based on the CBK report of 2018, KWFT reported a loss of 827 million despite having been reporting profits since 2015. Besides, many other microfinances made a net loss: Rafiki made a loss of 192 million, SMEP 22 million, Caritas 22 million, Key 10 Microfinance Bank Limited 14 million, Uwezo 27 million, Daraja 32 million, Maisha 119 million, Century 25 million and Choice 42 million (CBK 2018). Thus, it can be ascertained that most of the microfinance institutions make losses and thus formed the study's foundation. The making of the losses may be as a result of inefficiency in short term debt. However, the available information examining the impact of short term dept among deposit taking microfinances remains scantly. Previous studies presented a knowledge gap (contextual, conceptual and methodological gap). For instance, Bashir and Asad (2018) presented a conceptual, contextual and geographical gap with the current study. The study was done in the textile firms in Pakistan to examine the impact of board size on performance. Additionally, Godswill, Ailemen and Osabohien (2018) presented a contextual gap and conceptual gap. This study was conducted in the banking sector and the with the main objective of examining the effect of working capital management on performance. Further, Wambua (2018) examined the impact of capital structure on the financial supportability of deposit taking microfinance in Kenya and used primary data. It is against this background that the study intended to examine the effect of short-term debt on profitability among deposit-taking microfinance institutions.

Objective of the Study

The overall objective of this study was to examine the effect of short-term debt on profitability among deposit-taking microfinance institutions**.**

Significance of the Study

Policymakers are charged with the responsibility with coming up with relevant guidelines on microfinance institutions should follow in their undertakings while the regulator's role is seeing to it that the rules and laws are followed to the letter. This study may provide insight to policymakers on possible weaknesses of financial reporting, which can be amended or extended to curb any future problems in setting up new policies. This research renders invaluable information to analysts whose primary role is to analyze companies' performance to advise their clients accordingly.

The financial sector is vital in stimulating the growth of the economy in an area of concern and analysts may find this study of great help in terms of revealing the essential aspects finance seeking and financial prudence from the microfinance institutions. The existing and potential investors may learn from the study the importance of the extra information provided by management in their reports and in this manner may be in a position to settle on educated choices about where to invest or withdraw their capital thus reducing their cost of capital. Further, shareholders may get insight on why they should request for additional information about their investment. The study adds to the existing body of knowledge on the firm's financial leverage and profitability in deposit-taking microfinance institutions by bridging the gaps left out by past studies. This study may, therefore, be of benefit to future scholars and academicians where they may review the literature and learn more of the previous studies. The results of this study will carry value to the government and financial government bodies as it is anticipated to facilitate understanding the reason behind the rapid increase rate of innovations in the equity financing institutions specifically

THEORETICAL REVIEW

The study will benefit from the pecking order theory that was proposed by Myers (1984) and the agency cost theory that was proposed by Jensen (1986).

Pecking Order Theory

This Pecking Order Theory was developed by Myers and Majluf (1984), which proposes that the expense of financing increments with awry information. The theory states that managers of companies follow a specific hierarchy when considering the sources of financing for the company. The firm prioritizes their sources of funding in connection with the rule of the least exertion, which prefers to raise the equity as methods for the final resort. When the companies are faced with no alternative option in the internal financing of the business other than the external funding, then the most priority will borrow through the debt issue since its less risky (Allini, Rakha, McMillan& Caldarelli, 2018).

Moreover, the pecking order theory acknowledges that there is no target Capital structure. The organizations pick the degree of the capitals as per inside account, obligation, and value. The root of pecking order theory is from the enlightening asymmetry where chiefs find out about an associations prospect than the external lenders. The theory proposes that if the value 16 of the firm issues offers to back an endeavor, it needs to issue shares at not precisely the general market cost. This flag the offers are exaggerated and the administration isn't sure to serve the debt if the task is financed by debt pecking theory is very relevant to many businesses and allows for the dynamics of most of the firms to find out the best capital structure at a particular point (Copeland & Weston, 1988). The most profitable business in the World has a very low debt to value proportion and furthermore, the less beneficial firm in a similar industry will probably have a high obligation to-value proportion. Pecking order theory clarifies these watched and detailed administrative activities that are supposed to be taken seriously to improve in the performance. It additionally discloses securities exchange responses to use expanding and influence diminishing occasion in the market. (Serrasqueiro & Caetano, 2015).

However, the pecking order theory does not well illustrate the role of government intervention in the business. The effects of taxation, the financial shocks, the costs of issuance of the security and the arrangement of the venture's chances accessible to the business unit with the actual capital structure (Bhama, Jain, & Yadav, 2016). Moreover, the theory ignores the challenges that can emerge because of the administrators of the organizations collecting so much money related to leeway that they become resistant to the market discipline. In this way, the pecking order theory is offered as a supplement to, instead of substitution for, the conventional exchange off the model. The theory mostly concentrated on the advantages of the internal financing of the business as opposed to the external sources (Allini, Rakha, McMillan, & Caldarelli, 2018). The theory was relevant to the current study and it informed the variable of equity ratio.

Agency Cost Theory

Agency cost theory was spearheaded out by Jensen and Meckling (1976). The theory establishes choices affecting the execution of the duties in a company are generally made by 17 the management. The theory argues that with minimal supervision, the directors may choose to put resources into activities with negative net value (Bosse & Phillips,2016). Further, more elevated amount of debt expands investors' worth on account of its disciplinary impact on administrator conduct. The agency theory contends that when ownership and control in an organization are separate, the managers may act out of self-interest and are self-centered, thereby, giving less attention to shareholders' interests (Shi, Connelly & Hoskisson, 2017).

The separation of power and control in an organization may bring about supervisors seeking after various targets other than that of the firm, for example, perquisites, picking information sources or yields that their inclinations, or otherwise neglecting to amplify firm worth. Substantially, the agency cost of outside proprietorship equivalent to the lost an incentive from expert supervisors boosting their very own utility, rather than the estimation of the firm (Pouryousefi and Frooman, 2017). More prominent financial leverage may influence directors and diminish agency costs through the risk of liquidation, which makes individual misfortunes administrators of pay rates, notoriety, perquisites and additionally through a strain to produce income to pay interest cost (Dawar, 2016). The agency cost hypothesis contends that exceptionally leveraged firms can diminish the agency cost of outside equity and improves the association's presentation, which adequately builds firm worth.

Myers (1977) sees that exceptionally leveraged firms can relieve clashes among investors and supervisors concerning the decision of venture. It places that the determination of capital structure helps in moderating agency costs and thereby impacts fast execution (Parker, Dressel, Chevers and Zeppetella, 2018). In spite of the agency theory being immensely known to business and immensely being reliable to the organizations, it faces criticism from the scholars. For instance, Eisenhardt (1989), Shleifer and Vishny (1997) and Daily et al. (2003) (Panda and Leepsa, 2017). The theory expects a sound understanding between the head and operator for a restricted or the 18 boundless future period, and what's to come is unsure. Besides, the theory accepts that contracting can wipe out the agency issue, however for all intents and purposes, it faces numerous deterrents like data asymmetry, rationality, misrepresentation and exchange cost. The enthusiasm of the Investors' in the firm is to extend the benefits; in any case, their activity is obliged in the firm. The responsibilities of managers are just compelled to the administration, and their further job is not unmistakably characterized. The theory considers the administrators as astute and disregards the ability of the directors (Gong, Tang, Liu & Li, 2017).

Much as this theory affects leverage decisions that need to be taken to address agency conflict arising, it also helps in explaining the role played by top managerial staff in checking the specialists (directors) of the firm. The senior administrative staff as a governance mechanism helps in keeping on toes the managers who pursue self-interest at the expense of shareholder's wealth maximization objective. The board of director will effectively provide an oversight authority to guarantee that the interests of investors are not infringed by managers who are internal players in the firm they are serving. Hence the more significant the board sizes, the effective the monitoring role it is having over the agents. This theory supported the variable short-term debt by positing that highly leveraged firms can reduce the agency cost of outside equity and improves the firm's performance, which effectively increases firm value.

Empirical Review

Godswill, Ailemen and Osabohien (2018), assessed the working capital management and bank performance in Nigeria. The assessment included ten deposit-taking institutions in Nigeria. The examination reviewed how the benefits of banks can be overhauled through working capital administration. To experimentally do the evaluation, panel data included ten (10) deposits banks in Nigeria covering the period between 2010 and 2016 (2010–2016). The results of the examination displayed that working capital is a necessary measure for bank efficiency and sustainability. The study presented a contextual gap because it was conducted among the commercial banks while the current study was conducted among the microfinance institutions.

Moreover, Kalu, Shieler and Amu (2018), examined credit risk management and financial performance of microfinance institutions in Kampala, Uganda Haruna. The evaluation utilized 60 individuals from three affirmed microfinance establishments in Kampala, Uganda. Moreover, the data was obtained from the books of account between 2011 and 2015. The results showed that credit risks had a positive and significant relationship with the financial performance of MDI. The study presented a conceptual gap because it mainly focused on credit risk management.

Furthermore, Muthuri (2018), examined the impact of monetary stability on the financial performance of commercial banks in Kenya. The examination found a positive relationship existed between financial execution and performance. The assessment, likewise, established the composition of debts and equity funds are fundamental in deciding the profitability and adjusting the cost of operation of activities and the points of interest related with the financing option gotten by the organizations. The study presented a contextual gap since commercial banks were the unit of analysis.

Moreover, Wambua (2018), investigated the impact of capital structure on the financial sustainability of deposit-taking microfinance institutions in Kenya. The examination utilized an empirical study as the exploration plan. The analysis found that debts positively affected the performance. Borrowing by the organizations increased the accessibility of adequate assets to finance the accessible resources of the organization, which consequently improves in the degree of execution. The study presented a conceptual gap because it mainly focused on capital structure.

Hossain and Azam (2016), conducted a study in Bangladesh on the financial sustainability of microfinance institutions. The study relied upon on the primary data and the units of observation were managers. The findings of the study discovered that the proportion of capital resources, discount and working cost proportion impact enormously the money related supportability of microfinance organizations in Bangladesh. Nonetheless, the obligation value proportion and the outstanding credit to add up to resources and the level of borrowers had no huge effect on the money related supportability of MFIs in Bangladesh during the time of the investigation. However, the study presented a methodological gap because the study utilized primary data while the current used desktop literature review method.

METHODOLOGY

The study adopted a desktop literature review method (desk study). This involved an in-depth review of studies related to the effect of short-term debt on profitability among deposit-taking microfinance institutions**.** Three sorting stages were implemented on the subject under study in order to determine the viability of the subject for research. This is the first stage that comprised the initial identification of all articles that were based on the effect of short-term debt on profitability among deposit-taking microfinance institutions. The search was done generally by searching the articles in the article title, abstract, keywords. A second search involved fully available publications on the subject on influence of equity financing on the growth of micro, small and medium enterprises. The third step involved the selection of fully accessible publications. Reduction of the literature to only fully accessible publications yielded specificity and allowed the researcher to focus on the articles that related to the effect of short-term debt on profitability among deposit-taking microfinance institutions. After an in- depth search into the top key words (effect short term debt, profitability, deposit-taking, microfinance institutions), the researcher arrived at 5 articles that were suitable for analysis. This were findings from:

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SUMMARY, CONCLUSION AND RECOMMENDATIONS

Conclusion

From the findings of the study, the study concludes that short term debt had a positive and significant association on the profitability of the deposit-taking microfinance. The study also concludes that short term debt has a positive and significant relationship on the profitability of the deposit-taking microfinance. This means that profitability would increase with a proportionate increase in in the level of the short-term debt when all other factors affecting the profitability of the organizations are held constant. The study showed that when the company borrows, availability of sufficient funds to finance the available assets of the company, which in return improves in the level of performance.

Recommendations

Based on the coefficients of determination, the study recommends that policymakers in the microfinance institutions should use short term debt for the financing of the activities. The cost of the short-term debts is minimal and generally offers lower interest charges, and most lenders do not charge interest until all credit allowance period is breached and therefore becomes useful for companies.

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