



**EFFECT OF CASH FLOWS ON FINANCIAL PERFORMANCE OF FIRMS LISTED IN  
THE NAIROBI SECURITIES EXCHANGE**

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**Abstract**

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*A cash flow problem has been the major issue faced by listed firms in Kenya where by companies' struggles to pay their debts as they become due. This in turn causes low profits or extreme losses, excessive debts, negative operating cash flows, dwindling sales and diminishing gross profit margins. The intention of this research project was to establish the effect of cash flows on financial performance of firms listed on the Nairobi Securities Exchange. The dependent variable was financial performance measured by return on equity and independent variables were investing cash flows, financing cash flows and operating cash flows. The specific objectives of the study were: to find out the effect of operating cash flows on financial performance of firms listed in the Nairobi Securities Exchange; to establish the effect of investing cash flows on financial performance of firms listed in the Nairobi Securities Exchange and to determine the effect of financing cash flows on financial performance of firms listed in the Nairobi Securities Exchange. The theories forming a basis of this study were modern quantity theory of money and Keynesian theory of money. A descriptive research design was used in the study. Fifty companies were the population of interest in the research undertaken. The study was a census study and it utilized secondary data derived from published audited financial statements for the listed companies in the Nairobi Securities Exchange for the years 2010 to 2014. Data analysis involved inferential and descriptive statistics. The statistical software SPSS was used in data processing. The study found out that cash flows have a statistically significant effect on financial performance.*

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**Keywords:** Financing Cash Flows, Investing Cash Flows, Operating Cash Flows

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## 1. Background of the Study

Lack Worldwide there is an obsession with profits with little attention being paid to cash flows. In the view of Talebi (1996), a firm can survive in an economy for a long time whereas it's making little or no profit but the chances of survival minus liquidity are slim. Authors like Helfert (2001), Kew et al. (2006) and Powers and Needles (2011), assert that cash flows are categorized into three main elements. These elements are the operating, financing and investment activities.

The operating activities give an idea of how much cash an organization must have generated from its daily provision of its goods (Kew et al. 2011). In the view of Gentry et al (1990) operating cash flows help increase the financial and credit health of a company. Additionally, firms with high operating and investing cash flows have a low credit risk. An investigation done by Torfason (2014) revealed that Lehman Brothers exhibited a steady increase in profit growth from 2002 and a significant increase in revenue from 2001. For most of the year's operating cash flows were negative with a significant decline recorded in 2003. This raised no alarm unlike the case of non-financial firms where this could be a sign of impending bankruptcy.

Investing activity details the money generated by the business and money spent by an entity in investing in other firms and in the purchase and disposal of fixed assets (Power & Needles, 2011). Lastly investing cash flows can be used to gauge the strengths and shortcomings of a business (Bodie et al., 2004).

The last category is financing activity and it details the sources and uses of funds raised from outsiders and the shareholders (Powers and Needles, 2011). Cash inflow from financing activities includes cash proceeds from the issue of shares and loan borrowing. Cash payment from financing activities includes the following, money spent to repay the principal amount, redemption amount paid for ordinary and preference shares and cash dividends paid.

The main intention of accounting information is the provision of relevant and sufficient information that will be of help to both internal and external users to make decisions as regards a company's operations and performance (Soyade, 2007). Accounting information presented in the form of financial reports provides the facts to make rational decisions (Smith, Keith & Stephens, 1993).

According to the company Act 2015, financial statements required to be maintained by a company include: balance sheet, profit and loss account, statement of cash flows and statement of changes in equity. However for all the annual reports prepared only the statement of cash flow is prepared on cash basis. Kam (1990) claims that cash flow statement usefulness is vividly depicted by the insolvency of W.T Grant that analyzed by Largay III and Stickney (1980). Profit earned determines the efficiency of a corporation with greater profits equated to higher efficiency. Silky (2013) noted that profitability shows how well management can generate earnings. The assumption made in this research project is that sufficient cash inflow position of

a company has the propensity to improve its financial performance in the context of profitability. Consequently, financial performance in this study was measured using return on equity.

## **2. Statement of the Problem**

A cash flow problem has been the major issue faced by listed firms in Kenya where by companies' struggles to pay their debts as they become due. This can be worsened by low profits or extreme losses, excessive debts, negative operating cash flows, dwindling sales and diminishing gross profit margins. In a research done by Peavler (2009), it was noted that most failed businesses (up to 60%) were of the opinion that all or most of their failures were due to cash flow problems. According to KNBS (2007), three out of five firms fail within the first three years of operation due to cash flow problems. Uchumi Supermarkets (2005), the firm had a tight cash flow position and failed to maintain supplier relations and consistent supplies. This worsened the cash flow position which resulted in receivership. The study therefore sought to examine the effect of cash flows on the financial performance of firms listed in the NSE.

## **3. Supporting Theories**

### **Keynesian Theory of Money**

Feminism Keynes (1936), pointed out the three motive for the need of money, the transaction, the speculative motive and the precautions motive. The speculative motive is the necessity to hold cash to exploit profitable opportunities when they arise in financial markets. The precautionary motive is the need to hold cash to cater for unexpected or unanticipated events. The transaction motive is the necessity of having cash on hand to pay day to day expenses of an organization. Thus, a firm needs to maintain an optimal level of liquidity to avoid an adverse effect on financial performance.

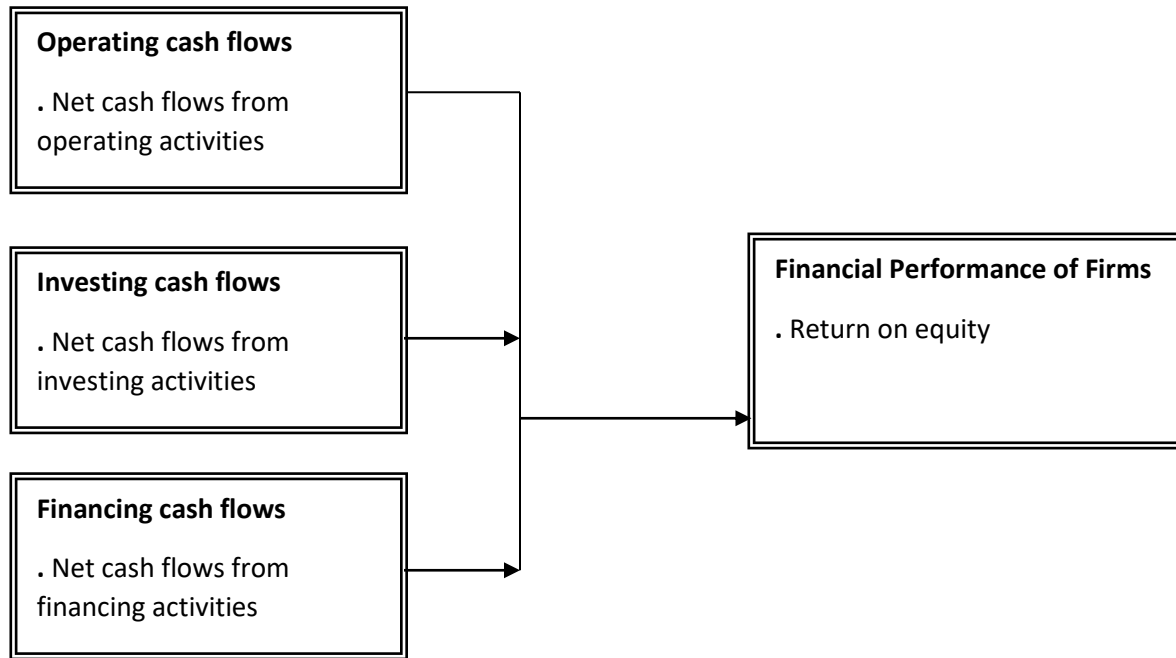
### **Baumol Cash Management Model**

Baumol (1952) developed the model to help one ascertain the cash amount a firm should hold. Thus in line with this theory, a target cash balance must be maintained by a firm which may adversely affect profitability due to opportunity costs incurred such as interest forgone.

#### 4. Conceptual Framework

**Independent Variable**

**Dependent Variable**



**Figure 1: Effect of Cash Flows on Financial Performance**

Financial performance was the dependent variable in the study. The independent variables in the research undertaken were operating, financing and investing cash flows.

#### 5. Research Design

The study adopted a descriptive research design. The target population was the 50 companies quoted in the NSE for the period 2010 to 2014. The study utilized secondary data. Data analysis was via inferential and descriptive statistics. Hypothesis testing was done using standard t and F tests. Multi variants analysis was used to come up with the following model:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Where

Y = Financial Performance.

X<sub>1</sub> = operating cash flows.

X<sub>2</sub> = investing cash flows.

X<sub>3</sub> = financing cash flows.

e = error term.

$\beta_0, \beta_1, \beta_2$  and  $\beta_3$  = Regression coefficients.

## 6. Findings

Detailed below are the findings from the study carried out.

**Table 1: Descriptive Statistics.**

	N	Minimum	Maximum	Mean	Std. Deviation
OPCASH	50	16110	7472000	3064491.66	22399212.982
INVCASH	50	4527180	90828898	80128925.43	2460697.263
FINCASH	50	183540	19987000	3883572.09	3349495.317
ROE	50	.0560	.5630	.277143	.1419839
Valid (listwise)	N 50				

The results indicated that investing cash flows as measured by the amount of net cash flows from investing activities per annum had the highest value of Kshs. 4527180 amongst the minimums and Kshs. 90828898 on the maximums. This means that companies trading in Nairobi Securities Exchange prefer to hold cash for investment purposes and this pattern could be attributed to speculative tendency of the investors. Equally investing cash flows returned the highest mean value of Kshs. 80128925.43 as compared to the other variables. Operating cash flows had the lowest value in terms of mean posting a value of Kshs 3064491.66 while financing cash flows posted a value of Kshs. 3883572.09. Further the standard deviation indicate that operating cash flows had the highest variation of Kshs. 22399212.982 during the five years of study as compared to the other variables while investing cash flows had the lowest variation of Kshs.2460697.263 for the same period. This high variance in operating cash flows can be attributed to the unpredictable nature of the demand for cash to facilitate daily activities of the firms. Thus due to the high volatility of operating cash flows firms should hold more cash to provide a safe cushion for smooth operations.

**Table 2: Correlation matrix on financial performance**

		Financing cash flows	Operating cash flows	Investing cash flows	Roe
Financing cash flows	Pearson Correlation	1	.609	.999**	-.769
	Sig. (2-tailed)		.276	.000	.129
	N	5	5	5	5
Operating cash flows	Pearson Correlation	.609	1	.643	-.368

	Sig. (2-tailed)	.276		.242	.542
	N	5	5	5	5
	Pearson	.999**	.643	1	-.770
Investing cash flows	Correlation				
	Sig. (2-tailed)	.000	.242		.128
	N	5	5	5	5
	Pearson	-.769	-.368	-.770	1
ROE	Correlation				
	Sig. (2-tailed)	.129	.542	.128	
	N	5	5	5	5

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

The study findings from the above table show that financing cash flows is positively correlated 0.609 to operating cash flows 0.999, while investing cash flows is negatively correlated to financial performance -.769 respectively. The findings revealed that financing of cash flow had inverse significant on financial performance. The study concluded that there was very strong statistical significant effect of investing cash flows on financial performance however the at 95% level (0.000) less than (0.001) implied that there is infinite relationship between investing cash flows and financial performance.

### Operating Cash Flows and Financial Performance

To determine the effect of operating cash flows on financial performance of listed firms a simple regression model of the form  $y=a+bx$  was used.

**Table 3: Coefficients of Operating Cash Flows**

Model	Un standardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1	(Constant)	.214	.037	5.839	.000
	OPCASH	2.053	.008	.356	2.188

The regression equation derived from the results was therefore  $Y= 0.214+2.054X$ . This means that increase in operating cash flows by 1 shilling increases a firm's profitability by Kshs.2.054. The standardized beta value of .356 indicates that an increase in operating cash flows by 1% causes an increase in profitability by 35.6%. Moreover a 64.4% increase in profitability is attributable to other factors apart from operating cash flows. Thus it is crucial for the

management of listed firms to maintain adequate levels of operating cash flows to be in a position to meet the daily obligations of the firms when they arise.

### Testing of Hypothesis I

**H<sub>01</sub>.** Operating cash flows have no significant effect on the financial performance of firms listed in the Nairobi Securities Exchange.

The calculated t value as indicated in Table 3, shows a value of 2.188 while the critical table value at 5% level of significance is 1.123. Therefore the null hypothesis that there is no significant effect of operating cash flows on the financial performance of listed companies fails to be accepted. This implies that there is a significant effect of operating cash flows on financial performance of listed companies in Kenya. Moreover the p-value of 0.036 that is less than 0.05 shows that operating cash flows have a significant effect on financial performance of listed firms.

**Table 4: Operating Cash Flows ANOVA**

Model		Sum of Squares	of Df	Mean Square	F	Sig.
1	Regression	.087	1	.087	4.785	.036 <sup>b</sup>
	Residual	.599	49	.018		
	Total	.685	50			

The F value in Table 4, indicates a substantially high figure of 4.550 as compared to the table value of 1.560 implying that the model is valid and can hold. The p-value of 0.001 is less than 0.05 significance level and therefore the model is a good model.

**Table 5: Operating Cash Flows Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.356 <sup>a</sup>	.127	.100	.1346845

Further the r squared value as shown in Table 5, shows that a change in operating cash flows causes a 12.7 % variation in financial performance of listed firms. This means that 87.3% of the variation in financial performance can be explained by other factors. The findings revealed that operating cash flows is a vital determinant of the profitability of listed firms. The higher the operating cash flows the higher is the profitability of the listed firms. These findings confirmed the study of Frank and James (2014) and Damian (2013) that found out that a statistically significant positive relationship exists between operating cash flows and financial performance. The above findings differ with the study of Mong'o (2010) where the researcher found out that a

negative relationship exists between operating cash flows and profitability of commercial banks in Kenya. Furthermore it varies with the study of Valipour, Shooshtarian and Ostovari (2012) where they established that operating cash flows have an insignificant effect on operating income of firms listed in the Tehran Stock Exchange.

### Investing Cash Flows and Financial Performance

To determine the effect of investing cash flows on financial performance of listed firms, a simple regression model of the form  $y=a+bx$  was used.

**Table 6: Coefficients of Investing Cash Flows**

Model	Un standardized		Standardized	T	Sig.	
	Coefficients	Std. Error	Coefficients			
	B		Beta			
1	(Constant)	.252	.023		10.867	.000
	INVCASH	2.893	.014	.465	3.019	.002

The regression equation derived from the results was therefore  $Y= .252+ 2.893X$ . This means that increase in investing cash flows by 1 shilling increases profitability by Kshs. 2.893. The standardized beta value of .465 indicates that an increase in investing cash flows by 1% causes an increase in profitability by 46.5%. This implies that other variables are responsible for 53.5% increase in profitability of firms listed in the NSE. Since investment projects require a significant capital outlay, the management of the listed firms should pay attention to ensure that maximum returns are achieved for every shilling spent.

### Testing of Hypothesis II

**H<sub>02</sub>.** Investing cash flows have no significant effect on the financial performance of firms listed in the Nairobi Securities Exchange.

The calculated t value as indicated in Table 6, shows a value of 3.019 while the critical table value at 5% level of significance is 1.123. Therefore the null hypothesis that there is no significant effect of investing cash flows on the financial performance of listed companies fails to be accepted. This implies there is a significant effect of investing cash flows of listed firms on their financial performance. Further the p-value of 0.002 is less than 0.05 significance level shows that investing cash flows are statistically significant.



**Table 7: Investing Cash Flows ANOVA**

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	.148	1	.148	9.115	.002
1	Residual	.537	49	.016		
	Total	.685	50			

The F value in Table 7, indicates a substantially high figure of 9.115 implying that the model is valid and can hold. The p-value of 0.002 is less than 0.05 significance level and therefore the model is considered a good model.

**Table 8: Investing Cash Flows Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.465 <sup>a</sup>	.216	.193	.1275741

Further the r squared value as shown in Table 8, indicates that a change in investing cash flows causes a 21.6 % variation in financial performance of listed firms. This means that 78.4% of the variation in financial performance can be explained by other factors. The findings revealed that investing cash flows have a significant effect on profitability of listed firms in Kenya. This finding agrees with the works of Adelegan (2003) who determined that a statistically significant positive relationship exists between cash flows and firm performance. This finding is in contrast to the works of Frank and James (2014) and Mong'o (2010) who arrived at the conclusion that the relationship between investing cash flows and firm performance is negative and statistically significant.

### Financing Cash Flows and Financial Performance

To establish the effect of financing cash flows on the financial performance of quoted firms a simple regression model of the form  $y=a+bx$  was used.

**Table 9: Coefficients of Financing Cash Flows**

Model	Un	standardized	Standardized	t	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
1	(Constant)	.197	.033	5.996	.000

FINCASH	2.063	.008	.487	3.201	.003
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The regression equation derived from the results was therefore  $Y = .197 + 2.063X$ . This means that increase in financing cash by 1 shilling increases the firm's profitability by sh.2.063. The standardized beta value of .487 indicates that an increase in financing cash flows by 1% causes an increase in profitability by 48.7%. This means other variables are responsible for increase in profitability of listed firms by 51.3%. In order to improve financial performance listed firms should focus in boosting financing cash flows.

### Testing of Hypothesis III

**H<sub>03</sub>.** Financing cash flows have no significant effect on the financial performance of firms listed in the Nairobi Securities Exchange.

The calculated t value as indicated in Table 9, shows a value of 3.201 while the critical table value at 5% level of significance is 1.123. Therefore the null hypothesis that there is no significant effect of financing cash flows on the financial performance of listed companies fails to be accepted. This implies that there is a significant effect of financing cash flows on the financial performance of listed companies in NSE. Further the p-value is less than 0.05 of significance level showing that financing cash flows has a significant effect on financial performance of manufacturing firms.

**Table 10: Financing Cash Flows ANOVA**

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	.162	1	.162	10.248	.003 <sup>b</sup>
1	Residual	.523	33	.016		
	Total	.685	34			

The F value in Table 10, indicates a substantially high figure of 10.248 implying that the model is valid and can hold. The p-value of 0.003 is less than 0.05 significance level and therefore the model is a good model.

**Table 11: Financing Cash Flows Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.487 <sup>a</sup>	.237	.214	.1258918

Further the r squared value as shown in Table 11, shows that a change in financing cash flows causes a variation of 23.7% in financial performance of listed firms. This means that 64.3% of the variation in financial performance can be explained by other factors.

The study confirms that financing cash flows has a significant effect on financial performance of quoted firms. This finding supports the finding of Mong’o (2010), who established that a statistically significant positive relationship exists between financing cash flows and profitability of commercial banks quoted in the Nairobi Securities Exchange. Frank and James (2014) also did a similar study for six food and beverages firms listed in the Nigerian Stock Exchange and drew the conclusion that a statistically significant positive relationship exists between financing cash flows and profitability.

### Multi-linear Regression Model

To find out the effect of the independent variables operating simultaneously on financial performance of companies listed in NSE, a multi-linear regression model of the form  $Y=\beta_0+\beta_1X_1+\beta_2X_2+\beta_3X_3+e_i$  was used.

**Table 12: Multi-linear Regression Coefficients**

Model	Un standardized		Standardized	t	Sig.
	Coefficients	Std. Error	Coefficients		
	B		Beta		
(Constant)	.174	.040		4.391	.000
1 OPCASH	1.206	.008	.209	1.343	.189
INVCASH	1.408	.014	.226	1.277	.211
FINCASH	1.379	.008	.325	1.906	.066

The multi-linear regression equation derived from the results was therefore

$Y= .174+1.206X_1+1.408X_2+1.379X_3$ . Using the standard beta coefficients it is evident that when investing cash flows and financing cash flows are held constant operating cash flows can explain 20.9 % of the variation in profitability of listed companies. On the other hand holding operating cash flows and financing cash flows constant, change in investing cash flows can explain 22.6% of the variation in performance of listed companies in Kenya. Also holding operating cash flows and investing cash flows constant financing cash flows can explain 32.5 % of the variation in financial performance.

**Table 13: Multi-linear Regression ANOVA**

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	.232	1	.077	5.278	.002 <sup>b</sup>
1	Residual	.454	49	.015		
	Total	.685	50			

The F value of 5.278 in Table 13 is significantly high and the model is considered valid and can hold. The p-values returned a value less than 0.05 level of significance meaning that the variables have significant effect on the value of the financial performance of a firm.

**Table 14: Multi-linear Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.581 <sup>a</sup>	.338	.274	.1209754

The coefficient of determination  $r^2$  of 0.338 shown in the Table 14 indicates that 33.8% of the variation in financial performance can be explained by the changes in operating cash flows, investing cash flows and financing cash flows. This implies that 66.2% variation in the financial performance of listed firms is attributable to other factors. The study confirms the findings of Mong'o (2010) who find out that a positive relationship exists between financing and investing cash flows. The higher the financing and investing cash flows the greater the financial performance. The above findings also vary from Mong'o (2010) who found out that operating cash flows have a negative effect on financial performance. The study found out that a positive relationship exists between operating cash flows and financial performance. Thus the higher the operating cash flows the higher the performance.

## 7. Summary of Findings

Detailed below is the summary of the findings arrived at.

### Operating Cash Flows and Financial Performance

The first objective of the study was to find out the effect of operating cash flows on the financial performance of firms listed in the NSE. The study revealed that operating cash flows had a standardized beta value of 0.356. This indicates that an increase in operating cash flows by 1% will increase profitability by 35.6%. The calculated t value was 2.188 as compared to the critical t value of 1.123 which shows that operating cash flows has a statistically significant effect on the financial performance. Operating cash flows had an R square of 0.127 which indicates that a

change in operating cash flows causes a variation of 12.7% in financial performance of quoted firms. Lastly when the three independent variables are operational at the same time, operating cash flows is responsible for 20.9% variation in financial performance of listed firms.

### **Investing Cash Flows and Financial Performance**

The second objective of the study was to determine the effect of investing cash flows on the financial performance of firms listed in the NSE. Investing cash flows had a standardized beta value of 0.465. This shows that a 1% increase in investing cash flows will translate to an increase in profitability of 46.5%. The calculated t value was 3.019 as compared to t table value of 1.123, this is a proof that factor investing cash flows is statistically significant. Investing cash flows had a R square of 0.216 which indicates a variation in investing cash flows causes a 21.6% variation in the financial performance of listed firms. When three independent variables used in the study operate at the same time, investing cash flows is responsible for a 22.6% variation in the financial performance of listed firms.

### **Financing Cash Flows and Financial Performance**

The third objective of the study was to ascertain the effect of financing cash flows on the financial performance of firms listed in the NSE. Financing cash flows had a standardized of 0.487. The implication of this is that an increase of 1% of financing cash flows will increase profitability by 48.7%. The computed t value was 3.201 as compared to table t value of 1.123 a clear proof that financing cash flows have a statistically significant effect on financial performance. Lastly when three explanatory variables operate at the same time financing cash flows causes a 32.7% variation in financial performance of firms listed in the NSE.

## **8. Conclusion**

The following were the conclusions drawn out of the study carried out:

### **Operating Cash Flows and Financial Performance**

The findings of the study confirmed that operating cash flows of listed companies affects financial performance of those companies significantly. This implies that firms that have more operating cash flows are in a position to generate higher profits since they can effectively pay their short term obligations on demand or over a short notice. This operating cash flow levels can be sustained by maintaining short-term marketable securities which can easily and quickly be converted into cash whenever there is need.

Operating cash flows are core to the running of the day to day activities of an organization and fulfillment of short term obligations. Its impact on profitability is evident because it is current activities that translate to future profits. However managing operating cash flows require a lot of financial discipline, right controls and financial prudence.

## **Investing Cash Flows and Financial Performance**

Secondly, investment projects require heavy capital outflow, a reason why its returns have to be carefully accounted for in order to yield maximum returns. Thus it's important that the firm pays attention to investing cash flows to reap the maximum profits from investments made because of the high capital expenditure associated with investment projects.

## **Financing Cash Flows and Financial Performance**

Finally financing cash flows has a significant effect on financial performance of listed companies in Kenya. The higher the financing cash flows the higher is the profit generated by quoted entities.

### **9. Recommendations**

The following were the recommendations drawn from the study conducted:

Listed companies should at all times maintain sufficient levels of operating cash flows in order to offset their daily obligations as and when they arise. This in effect will go a long way in ensuring confidence in the minds of the clients and other potential investors served by these companies. The long term impact of maintaining sufficient levels of operating cash flows is that most clients and investors will in the long run be attracted to the company.

Listed firms should also ensure they invest in potentially viable projects which can generate substantial amounts of cash. Acquisition and retention of highly valued assets with long-term capacity to convert raw materials into finished goods is a necessity if listed firms have to operate at minimal cost.

Management of firms and other organization must exercise great caution on the nature of financing source to be adopted in order to minimize cost of obtaining and maintaining funds in the firm. Viable investment opportunities should be sought at all times by the firm and exploited to make optimal use of the obtained funds.

### **10. Suggestions for Further Study**

The researcher recommended a similar study for companies which are not listed in Nairobi Securities Exchange most of which were privately owned. The rationale for this is to find out whether similar findings as established in the above study will hold for privately owned entities.

The study also revealed that there exists some correlations among the independent variables operating, investing and financing cash flows. This is depicted by slight decline on the variations of financial performance resulting from the various independent variables in the overall multi-regression model unlike the case when simple regression analysis was conducted for each of those independent variables separately. This evidenced there is some correlations among the

variables and thus future researchers should conduct an investigation to determine the association between the various independent variables.

The study recommended that future researchers should conduct a similar study over a longer period of time. This is because the researcher did the study on a shorter time frame of five years and thus recommends a similar study to prove whether the same relationship established will hold in the long run due to the impact of fluctuations in the macroeconomic front like political, legal, technological and economic factors.

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