

# The Effect of Activity-Based Costing and Financial Performance of Selected Microfinance Institutions in Kenya

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## ABSTRACT

The study investigated the effect of activity-based costing on the financial performance of selected microfinance institutions in Kenya. The study was anchored on agency theory and used both descriptive and correlational research designs, targeting 56 respondents from 14 licensed microfinance institutions in Kenya. The respondents included managing directors, regional managers, branch managers, loan officers, and operational managers. Primary data were obtained from self-guided questionnaires, and reliability tests were performed to assess the reliability of the study constructs using Cronbach's alpha. The questionnaire was also subjected to experts in the fields of finance and banking. The findings revealed that activity-based costing had a statistically significant positive effect on financial performance, with a correlation coefficient of 0.718 and a coefficient of determination of 0.516. The study concluded that microfinance institutions in Kenya can improve financial performance by adopting activity-based costing. The findings provide valuable insights for microfinance institutions, policymakers, regulators, and other stakeholders seeking to strengthen institutional performance and improve service delivery to underserved populations.

**Keywords:** Activity-Based Costing, Financial Performance, Microfinance, Agency Theory

## Background of the study

Strong financial performance ensures organizational sustainability, builds stakeholder confidence, and enables institutions to expand services and create long-term value. Financial performance refers to the ability of an organization to generate profits, maintain positive cash flows, and achieve sustainable growth (Hu et al., 2021). It is an all-inclusive measure that incorporates various financial metrics such as revenue growth, profitability ratios (e.g., gross profit margin, net profit margin), return on assets (ROA), return on equity (ROE), and working capital position (Fatihudin, 2018). Several financial indicators are used to evaluate an organization's financial performance. These metrics offer insights into the profitability, liquidity, effectiveness, and general financial well-being of the company. Revenue growth, gross profit margin, net profit margin, return on equity (ROE), return on assets (ROA), and working capital position are a few examples of financial performance metrics (Fatihudin, 2018).

Microfinance institutions were set up to help low-income people and small businesses access financial services (Omowole et al., 2024). The microfinance movement started to gain recognition in the 1970s thanks to institutions like the Grameen Bank in Bangladesh. They provided loans, savings options and other financial services to people who needed them. By making financial services more accessible, these institutions have helped promote inclusion, reduce poverty and support economic growth, (Chesang, 2017). Microfinance institutions are supposed to do financially and also help people who do not have a lot of money. They need to make money, use their resources well, and keep growing so they can keep helping these communities. To see how well they are doing, people look at things like how much money they make from their assets and how well they lend money.

The Activity-Based Costing method ensures enhanced accuracy in cost-benefit analysis and contributes to the overall improvement of organizational performance (Al-Dhubaibi, 2021). The utilization of the ABC approach, as well as its popularity, arose as a result of organizations seeking to reduce alterations caused by the misallocation of secondary costs (Jiménez et al., 2020). This costing method allocates departmental indirect costs by first attributing them to activities and subsequently to products using cost drivers. Within this methodology, drivers symbolize the primary factors influencing activity costs. This approach brings a sense of structure to cost distribution, minimizing arbitrary allocations. The principle is that products bear the costs of activities in alignment with the proportional utilization of the cost objects (Al-Hashimi & Al-Ghazali, 2023).

Microfinance institutions need to use Activity Based Costing. This means they need to plan and make good budgets, and keep an eye on their costs (Mwila et al., 2022). They also need to be able to make decisions based on the financial information they have (Mwirichia, 2023). When they do these things well, they can use their resources efficiently and do better as an organization. Some studies have shown that microfinance institutions that use management techniques do better financially and can keep going for a long time. For example, some microfinance institutions in Kenya used these techniques and did better financially, which means they made more money from their assets and had better interest margins (Durango et al., 2022). Microfinance institutions like these can really make a difference in the lives of low-income people and underserved communities by providing them with the services they need. Despite the ideal expectation, many MFIs continue to experience financial performance challenges arising from weak financial management systems and inadequate utilization of managerial accounting techniques (Mansourinia & Badsar, 2023). Rahman et al. (2022), in their study on financial management practices and performance of MFIs, found that many institutions lacked the expertise and infrastructure required to implement advanced managerial accounting systems, resulting in inefficient resource allocation and weak cost management. Similarly, Khan et al. (2020), in a study examining managerial accounting systems in microfinance institutions, reported that inadequate performance monitoring mechanisms contributed to poor financial outcomes and constrained institutional growth. Hossain (2019), in a study on accounting practices in MFIs, further observed that many institutions had not fully integrated managerial accounting techniques into their operations, limiting their ability to make informed financial decisions. In addition, Alam et al. (2020) and Ahmed et al. (2021) noted that existing microfinance research had largely focused on the social and developmental impact of microfinance while providing limited empirical evidence on the effectiveness of managerial accounting practices in enhancing financial performance. Consequently, many MFIs continue to struggle with operational inefficiencies, poor cost control, and financial sustainability challenges despite their growing importance in financial inclusion.

The contrast between the ideal and actual situations reveals a significant gap in the financial management of microfinance institutions. While MFIs are expected to achieve sustainable profitability, operational efficiency, and strong financial performance through effective financial management practices, many continue to face challenges related to poor resource allocation, inadequate cost control, weak performance monitoring, and limited managerial accounting capabilities. Although existing studies acknowledge the importance of managerial accounting techniques and generally report positive associations with financial performance, they provide insufficient evidence regarding the extent to which specific managerial accounting techniques are adopted and how they influence financial performance outcomes in MFIs. This gap underscores the need for further investigation into managerial accounting techniques such as activity-based costing, quality costing management techniques, and target costing techniques. Strengthening the adoption and utilization of these techniques could enhance decision-making, improve cost management, optimize resource allocation, and ultimately improve the financial performance and sustainability of microfinance institutions.

## Objective of the Study

To determine the effect of activity-based costing on the financial performance of selected microfinance institutions in Kenya.

## Research Hypothesis

H<sub>0</sub>1: Activity-based costing has no statistically significant effect on the financial performance of selected microfinance institutions in Kenya.

## THEORETICAL LITERATURE

### Agency Theory

Agency Theory was developed by Jensen and Meckling in 1976 (Jensen & Meckling, 1976). This theory is about the relationship between the people who own a company and the people who manage it. The owners give the managers the power to make decisions for them. Sometimes the managers do things that are good for them but not good for the owners. This can cause problems. Make the company do poorly. To fix this, Agency Theory says that the owners should watch the managers closely and give them reasons to do what is best for the company.

In companies that give loans to people, Agency Theory says that good accounting can help the owners know what is going on. This can make the company run better and make money. Agency Theory is based on some ideas about how the owners and managers interact. It assumes that both the owners and the managers are trying to get what they want. Sometimes what the managers want is not what the owners want. This can cause problems. So, the company needs to have rules and accounting practices. This helps make sure that the managers are doing what is best for the company. Agency Theory is important because it helps us understand the relationship between the owners and the managers of a company, like microfinance institutions. Agency Theory says that the owners should use it to make sure the managers are doing their job (Jensen & Meckling, 1976). Agency Theory is a way to make sure that the managers are working for the company, not for themselves. Second, the theory assumes that information asymmetry exists because managers possess more information about organizational operations than owners, making effective monitoring necessary. The Agency Theory says that managers might do what is best for themselves unless there are systems in place to control them and tools to measure how well they are doing. It also says that if we design contracts and monitor managers properly, we can reduce the costs that come with managers acting in their own interests. This is because their interests will be the same as the organization's. The Agency Theory also says that when we use financial and non-financial information to evaluate the decisions managers make, the organization will do better.

Even though the Agency Theory is used a lot in research about organizations and money, it has some problems. One big issue is that it thinks managers are only looking out for themselves. It does not consider things like being professional, doing the right thing, and being motivated to do a good job. These things can make managers behave better. The theory mostly cares about making shareholders richer. The Agency Theory also does not think about environmental goals, which is a problem for organizations like microfinance institutions that want to make money and do good things for society. The Agency Theory is useful for understanding how it can help managers make consistent decisions, with the financial goals of microfinance institutions.

### Empirical Literature

George et al., (2022) assessed whether adoption of Activity Based Costing (ABC) method has improved the financial performance of Consumer Goods Manufacturing Companies in Nigeria. We obtained time series data on company cost, return on capital employed, asset turnover, current ratios, financial gearing, and earnings per share from the annual financial statements of the companies under our study. The research data covered ten financial years, which comprised of both the pre-ABC adoption period and the post-ABC adoption period in equal numbers. A quasi-experimental research design was adopted to guide the direction of the study. The population of the study comprised all Consumer Goods Manufacturing Companies listed on the Nigeria Stock Exchange, while the sample comprised consumer goods manufacturing companies in Nigeria that have adopted an activity-based costing system. Chow test, a structural stability version of the ordinary least squares method of econometric regression, was used with the aid of the Statistical Package for Social Sciences (SPSS) version 25 to analyze the data. The analyses revealed that activity-based costing has no significant effect on the financial performance of the adopters

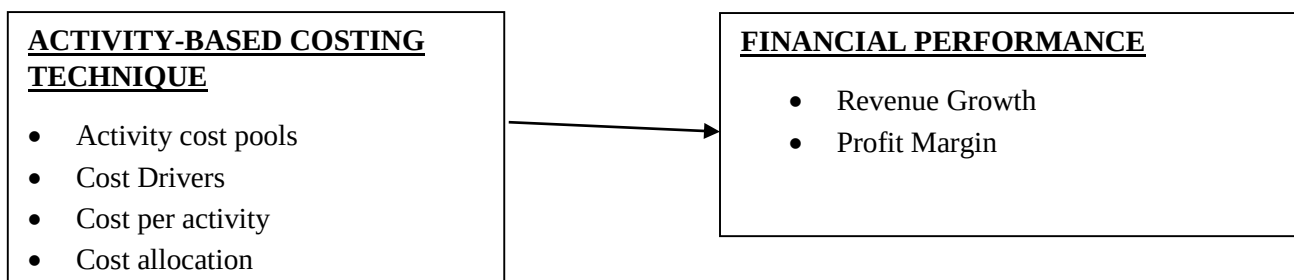
Alrjoub et al., (2023) conducted a study on the use of performance measurement systems, including Activity-Based Costing (ABC), in outsourcing decisions and their effect on financial performance among manufacturing firms in Jordan. The study looked at manufacturing firms that used Activity-Based Costing as part of their performance measurement systems. It wanted to see how Activity-Based Costing affected outsourcing decisions and financial performance. The study found that companies using Activity-Based Costing got accurate information about their costs. This helped managers decide what activities were worth doing and what were not when they made outsourcing decisions.

Abdilahi et al., (2023) the effect of activity-based costing on financial performance of the manufacturing industry in Kenya. The study used both qualitative and quantitative research method. The target population of the study was 100 middle level management. The study used primary source of data that was collected through questionnaire that consisted of structured questions. Quantitative data was collected analyzed through descriptive analysis and SPSS presentations was presented through percentages, means, standard deviations, and frequencies. The information was displayed by use of frequency tables. The study findings revealed that financial performance of manufacturing industry in Kenya was significantly related with activity-based costing. The activity-based costing had positive influence on performance. The study concluded that activity-based Costing (ABC) have positive influence on cement manufacturing firms as it enhances cost reduction which portend a high increase in profit and overall performance of an organisation.

## Conceptual Framework

### INDEPENDENT VARIABLE

### DEPENDENT VARIABLE



**Figure 1**

**Researchers Own Conceptualisation (2025)**

## RESEARCH METHODOLOGY

This study employed both descriptive and correlational research designs to comprehensively address the research objectives. The correlational research design was adopted to examine the causal relationships between the independent variable, activity-based costing, and the dependent variable of financial performance, while also investigating the moderating effect of corporate social responsibility. The study was conducted in Kenya, focusing on selected microfinance institutions, specifically the licensed deposit-taking microfinance institutions regulated by the Central Bank of Kenya. The study looked at microfinance institutions (MFIs) in Kenya that take deposits and have a license. Kenya was chosen for the study because its microfinance sector is well-developed and has rules in place. This makes it a good place to study how MFIs manage their accounts. The target population for this study comprised management and financial personnel from the 14 selected microfinance institutions, that is, the licensed deposit-taking microfinance institutions operating in Kenya. The target population included managing directors representing the highest level of strategic decision-making, regional managers responsible for multi-branch operations, branch managers overseeing local implementation, loan officers and credit managers directly involved in core. The total target population consisted of 56 respondents across the 14 deposit-taking microfinance institutions, comprising four individuals from each institution to ensure comprehensive representation of different management levels and functional areas. The census method was used since the target population was very small.

## RESULTS AND DISCUSSION

**Table 1: Multicollinearity Test Results**

| Variable               | Tolerance | VIF   | Decision             |
|------------------------|-----------|-------|----------------------|
| Activity-Based Costing | 0.642     | 1.558 | No Multicollinearity |

Source: Field Data (2025)

The multicollinearity test results indicate that Activity-Based Costing had a tolerance value of 0.642 and a Variance Inflation Factor (VIF) of 1.558. Since the tolerance value is greater than 0.10 and the VIF is well below the recommended threshold of 10 (and also below the more conservative threshold of 5), the findings indicate that multicollinearity was not a concern, implying that the variable could be reliably included in the regression analysis.

### Homoscedasticity Test

Homoscedasticity refers to the assumption that the variance of residuals is constant across all levels of the independent variables. The Breusch-Pagan test was conducted to assess whether this assumption is met. Table 2 presents the results of the homoscedasticity test.

**Table 2: Homoscedasticity Test Results (Breusch-Pagan Test)**

| Model                         | Lagrange Multiplier | df | Sig.  | Decision      |
|-------------------------------|---------------------|----|-------|---------------|
| ABC and Financial Performance | 2.845               | 1  | 0.092 | Homoscedastic |

Field Data (2025)

The Breusch-Pagan test produced a Lagrange Multiplier statistic of 2.845 with 1 degree of freedom and a p-value of 0.092. Since the significance value is greater than the 0.05 threshold, the null hypothesis of homoscedasticity was not rejected, indicating that the error variances were constant and the assumption of homoscedasticity was satisfied for the regression model.

### Linearity Test

The linearity assumption requires that the relationship between independent and dependent variables be linear. This was assessed using scatterplots and the Ramsey RESET test for functional form specification. Table 3 presents the linearity test results.

**Table 3: Linearity Test Results (Ramsey RESET Test)**

| Relationship                | F-statistic | df1 | df2 | Sig.  | Decision |
|-----------------------------|-------------|-----|-----|-------|----------|
| ABC → Financial Performance | 1.456       | 2   | 35  | 0.247 | Linear   |

Source: Field Data (2025)



The Ramsey RESET test yielded an F-statistic of 1.456 with 2 and 35 degrees of freedom and a p-value of 0.247. Since the significance value is greater than 0.05, the null hypothesis that the model is correctly specified was not rejected, indicating that the relationship between Activity-Based Costing and Financial Performance is linear and the linearity assumption was satisfied.

### Descriptive Statistics for Activity-Based Costing Techniques

**Table 4: Descriptive Statistics for Activity-Based Costing Techniques**

| Statement                                                                                   | SA (%)       | A (%)        | U (%)       | D (%)      | SD (%)     | Mean        | Std. Dev    | Tolerance    |
|---------------------------------------------------------------------------------------------|--------------|--------------|-------------|------------|------------|-------------|-------------|--------------|
| ABC provides more accurate allocation of costs compared to traditional costing methods      | 15<br>(37.5) | 18<br>(45.0) | 4<br>(10.0) | 2<br>(5.0) | 1<br>(2.5) | 4.10        | 1.02        | 0.758        |
| ABC enhances understanding of cost drivers and their impact on financial performance        | 12<br>(30.0) | 20<br>(50.0) | 5<br>(12.5) | 2<br>(5.0) | 1<br>(2.5) | 4.00        | 0.97        | 0.823        |
| ABC improves decision-making by providing reliable cost information for resource allocation | 14<br>(35.0) | 17<br>(42.5) | 6<br>(15.0) | 2<br>(5.0) | 1<br>(2.5) | 4.03        | 1.05        | 0.691        |
| ABC positively affects the ability to identify and manage cost-saving opportunities         | 11<br>(27.5) | 19<br>(47.5) | 7<br>(17.5) | 2<br>(5.0) | 1<br>(2.5) | 3.93        | 0.99        | 0.745        |
| ABC contributes to better cost control and cost management practices                        | 13<br>(32.5) | 18<br>(45.0) | 6<br>(15.0) | 2<br>(5.0) | 1<br>(2.5) | 4.00        | 1.01        | 0.712        |
| ABC enhances the ability to evaluate the profitability of different products or services    | 10<br>(25.0) | 21<br>(52.5) | 6<br>(15.0) | 2<br>(5.0) | 1<br>(2.5) | 3.93        | 0.95        | 0.789        |
| ABC has a positive impact on financial performance and profitability                        | 16<br>(40.0) | 16<br>(40.0) | 5<br>(12.5) | 2<br>(5.0) | 1<br>(2.5) | 4.10        | 1.04        | 0.698        |
| <b>Overall ABC Score</b>                                                                    |              |              |             |            |            | <b>4.01</b> | <b>0.72</b> | <b>0.745</b> |

Source: Field Data (2025)

The highest mean scores were recorded for statements regarding ABC providing more accurate cost allocation compared to traditional methods ( $M = 4.10$ ,  $SD = 1.02$ ) and ABC having a positive impact on financial performance and profitability ( $M = 4.10$ ,  $SD = 1.04$ ). These findings suggest that respondents strongly recognize the superior accuracy of ABC over conventional costing methods and acknowledge its contribution to improved financial outcomes. Activity-based costing statements were looked at. The ones that got the lowest scores were about how activity-based costing helps figure out if products or services are making money and how it helps find ways to save costs. Even though these statements got the lowest scores, people still thought they were good ideas. They just did not think they were as good as some things about activity-based costing.

The numbers that showed if the activity-based costing statements were related to each other were all good. This means that each statement was measuring something about activity-based costing. The statement that got the number was about how activity-based costing helps people understand what makes costs go up or down. The statement that got the number was about how activity-based costing helps managers make good decisions.

People's opinions about activity-based costing statements did not vary much. Most people. Agreed or strongly agreed with all the statements. Between 75 percent and 82.5 percent of people agreed with the statements, while between 7.5 percent and 10 percent did not agree. Not many people had no opinion about activity-based costing. This means that most people had an idea about whether or not activity-based costing was working for their institution. Overall, it seems like people think activity-based costing is a way to manage costs and make their institutions run better. Activity-based costing is seen as a way to make institutions more efficient, help managers make good decisions, and improve financial results.

### Regression Analyses

Simple linear regression analyses were performed to examine the effect of activity-based costing on financial performance. These analyses provided insights into the unique contribution of each technique and established the foundation for testing the research hypotheses.

**Table 5: Regression Analysis Results: Activity-Based Costing and Financial Performance**

| Analysis Component             | Value                       |            |
|--------------------------------|-----------------------------|------------|
| <b>Model Summary</b>           |                             |            |
| R                              | 0.718                       |            |
| R Square                       | 0.516                       |            |
| Adjusted R Square              | 0.503                       |            |
| Standard Error of the Estimate | 0.494                       |            |
| <b>ANOVA</b>                   |                             |            |
|                                | Sum of Squares              | Df         |
| Regression                     | 9.842                       | 1          |
| Residual                       | 9.272                       | 38         |
| Total                          | 19.114                      | 39         |
| <b>Coefficients</b>            |                             |            |
|                                | Unstandardized Coefficients |            |
|                                | B                           | Std. Error |
| (Constant)                     | 1.329                       | 0.389      |
| Activity-Based Costing         | 0.674                       | 0.106      |

Source: Field Data (2025)

Simple linear regression analysis was conducted to examine the relationship between activity-based costing techniques and financial performance in microfinance institutions. The regression model tested was: Financial Performance =  $\beta_0 + \beta_1(\text{Activity-Based Costing}) + \varepsilon$ . Table 5 presents the comprehensive results of the regression analysis.

The model summary indicates that activity-based costing techniques explain a substantial portion of the variance in financial performance. The correlation coefficient ( $R = 0.718$ ) demonstrates a strong positive relationship between ABC techniques and financial performance. The coefficient of determination ( $R^2 = 0.516$ ) reveals that activity-based costing techniques account for 51.6% of the variance in financial performance among the sampled microfinance institutions.

The adjusted  $R^2$  (0.503) provides a more conservative estimate, accounting for the number of predictors in the model, and confirms that the relationship remains substantial even after adjustment.

The ANOVA results demonstrate that the regression model is statistically significant ( $F(1,38) = 40.315$ ,  $p < 0.001$ ). The F-statistic indicates that the model fits the data significantly better than a model with no predictors, providing strong evidence that activity-based costing techniques have a genuine predictive relationship with financial performance. The significance level of 0.000 ( $p < 0.001$ ) far exceeds the conventional alpha level of 0.05, indicating extremely high confidence in the relationship.

The coefficients table reveals the specific nature of the relationship between activity-based costing and financial performance. The constant term ( $\beta_0 = 1.329$ ,  $p = 0.002$ ) represents the expected level of financial performance when activity-based costing techniques are not implemented or are at zero level. The regression coefficient for activity-based costing ( $\beta_1 = 0.674$ ,  $p < 0.001$ ) indicates that for every one-unit increase in the implementation or effectiveness of ABC techniques, financial performance is expected to increase by 0.674 units, holding all other factors constant.

The standardized coefficient (Beta = 0.718) confirms the strength of the relationship. It indicates that a one-standard-deviation increase in activity-based costing techniques is associated with a 0.718-standard-deviation increase in financial performance. The t-statistic ( $t = 6.350$ ,  $p < 0.001$ ) demonstrates that the relationship is highly significant and that the coefficient is substantially different from zero.

The study shows that using activity-based costing techniques really helps microfinance institutions do better financially. The numbers show that activity-based costing techniques explain a lot of the reasons why some microfinance institutions do better than others. This means that using activity-based costing is not a good idea; it is actually very important for an organization to be successful. Also, the study found that when microfinance institutions use activity-based costing more, they tend to do better financially.

The study found a strong connection between using activity-based costing and doing better financially. This connection is not a coincidence; it is real. So, the study concluded that activity-based costing techniques really do help microfinance institutions in Kenya do better financially. The study looked at deposit-taking microfinance institutions in Kenya and found that using activity-based costing techniques has a big and positive effect on their financial performance.

Based on these statistical results, the null hypothesis  $H_{01}$  is rejected at the 0.05 significance level. The extremely low p-value ( $p < 0.001$ ) provides overwhelming evidence against the null hypothesis. The positive regression coefficient indicates that activity-based costing techniques have a significant positive effect on financial performance in microfinance institutions. The substantial  $R^2$  value confirms that this relationship is not only statistically significant but also practically meaningful. The conclusion for hypothesis one is that there is sufficient statistical evidence to support the alternative hypothesis. Activity-based costing techniques significantly and positively affect financial performance in Kenyan microfinance institutions. This finding suggests that microfinance institutions that implement and effectively utilize



## CONCLUSION

The findings revealed that activity-based costing techniques have a statistically significant positive effect on financial performance in microfinance institutions ( $\beta_1 = 0.674$ ,  $p < 0.001$ ,  $R^2 = 0.516$ ). This result aligns with recent empirical evidence showing positive associations between ABC adoption and improved financial outcomes in complex organizational environments. The finding supports studies by Charaf et al., (2022), who found positive associations between activity-based costing and performance in Moroccan companies. However, it contrasts with some research that observed mixed or negative relationships in certain contexts.

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