CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN EMBU COUNTY, KENYA

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JUNE, 2017
DECLARATION

I hereby declare that this is my original work and has not been presented for an academic award in this or any other University.

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APPROVAL

This work has been submitted for examination with my approval as University Supervisor.

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DEDICATION

Special dedication to my two daughters (Makena and Wendo) for their inspiration, patience and encouragement
ACKNOWLEDGEMENTS

This research project has not been an easy task, first and foremost is to acknowledge the almighty God for being with me from the beginning to the end and also giving me strength and ability that enabled me accomplish. To my supervisor, Dr. Job Omagwa I convey sincere gratitude for the constructive suggestions and professional guidance through this project. My colleagues at place of work, can’t forget your support and encouragement. Lastly to my two daughters you have indeed given me special support and being part of me through this uphill task. To those not mentioned by name, accept my sincere appreciation and gratitude.
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ABSTRACT

This study was to find out how capital structure affects financial performance of small and medium enterprises in Embu County. There has been an enormous development in Embu SME’s for the last four years. Notwithstanding the undeniable significance of cost of capital, it’s effect on financial performance is not always obvious for there is empirical evidence of a negative effect between financial performance and cost of capital. The definite intention of the study was to determine the effects of; equity capital, retained earnings and debt capital on financial performance of SMEs. To conduct the survey the researcher used the causal research design. All 95 registered SMEs in Embu County as at 31st December 2016 formed the target population. A sample of 29 (30%) was selected from the target population by use of stratified random sampling techniques. To enhance collection of primary data questionnaires were administered by use drop and pick up later technique to the sampled respondents. For a detailed examination of quantitative data Statistical Package for Social Sciences (SPSS version 20) data software was applied. Regression analysis was done and gave different results on the three independent variables (equity capital, debt capital and retained earnings). The study findings established that equity capital has a significant effect on financial performance of SMEs due to a p-value of 0.021. The study also indicated a p-value of 0.020 on debt capital hence a significant effect on financial performance of SMEs in Embu County. On retained earnings, the study found a p-value of 0.797 indicating a no significant effect on financial performance of SMEs in Embu County. Further study findings concludes that, taking all factors into account (equity capital, debt capital and retained earnings) constant at zero, financial performance of SMEs is 2.473. The study established that equity capital had greatest proportion in capital structure; this was enhanced by its advantages like owner enjoying profit alone and independence in management. On debt capital the study found, it’s a source of capital that can enhances financial performance of a business, however it’s very risky if not well managed. On retained earnings, the study found it has no significance effect on financial performance of SMEs due to difficulties of raise and maintaining it. The researcher suggests lending institutions should enhance their lending policies and develop tailormade programs that will see debt capital a less risky source of finance. The study concluded that a mix of sources of finance will enhance a sound financial performance.
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ABBREVIATIONS AND ACRONYMS

EBIT: Earnings before interest and tax
PBIT: Profit before interest and tax
EPS: Earning per share
IFC: International Finance Corporation
IO: Institutional Investors
PIO: Public initial offer
ROA: Return on Asset
SMES: Small and Medium Enterprises
KIE: Kenya Industrial Estate
### OPERATIONAL DEFINITION OF TERMS

**Borrowed Capital:** is the money that does not belong to the owner of the business? The owner borrows to boost the operations of the business and repays later as per terms and conditions.

**Capital Structure:** Refers to the composition of capital employed. As regards this study, it is the mixture of ordinary shares, retained earnings and debt capital.

**Informal Sector:** Sectors which do not fall formalities when running their operations like complete double entry in bookkeeping eg. Clothing in industry, fruits and cereal sellers, stationery shops mobile phone industries

**Micro Finance Institutions:** These are a small financial institution that offers financial services to low income.

**Profile:** This refers to a summary of the main characteristics or features of an entity. In this study, it refers to the socio-economic characteristics of SMEs.

**Small and Medium Scale Enterprises:** In this paper, SMEs shall represent the small owned businesses that are in dire need of finance but do not attract the financial institution due to lack of collaterals

**Financial performance** is an absolute way of measuring how effectively the management is utilizing the limited resources to generate revenue for the business. How SME’s are able to invest the available finance and returns and growth of their business. Measured by profitability levels in different time periods.
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

One of the most difficult subject to understand in corporate finance literature is the capital structure. (Barine 2012). Capital structure is the composite of borrowed fund and owners’ fund that adds up to total capital employed of the business organization. The ratio of external source (borrowed) to internal source is a cautious decision for corporate managers. Capital structure decisions are of importance when considering the factors that affects performance of a firm. This therefore calls for a lot of care and attention when making decisions on capital structure. Referring to the balance sheet of a firm, a comprehensive status of the firm as regards all types of assets and liabilities are reflected (Velnampy and Niresh, 2012). The term capital structure of an enterprise is actually a mixture of ordinary share, preferred shares and long-term debts. A number of considerations requires to put in place as far as the optimum capital structure is concerned. With the combination of various sources of capital, firms may find it difficult to realize the goal of utilizing their funds economically. Therefore, it is progressively relied that a firm need organize its capital structure for an optimum use of funds and to be in a position that enhance dealing with upcoming situation (Pandy 2009)

According to Pandy (2009) financial performance measures of an institution includes profitability and liquidity among other that provides useful parameters for measuring the previous performance of the firm as well as the present status of the business. How well a business utilizes its assets in its operations to generate profit signifies its performance that is measured subjectively. Brigham and Gapenski (1996) supported the theory of Modigliani and Miller model. On the other hand, the presence of bankruptcy costs goes hand in hand with the firms debt. According to the conclusion an explicit association amid capital structure and financial performance of institution was suggested (Brigham and Gapenski 1996). The inspiration for aiming the SME’s comes from the fact that, they are force behind thriving in a number economy in today’s world. They create many jobs both self-employed and formally employed hence
contributing tremendously to economies which Kenya is not an exception and more so Embu County.

SMEs in Embu plays a very major part in the county’s economic growth varying from job creation, providing livelihood to the residents and enhances county development by paying trading license fees. Any individual that wants to start a SMEs type of business in Embu County must register with County Trade and License Office. Must also abide with policies and by-laws set by the county government. This uplifts their goodwill and makes it easy when accessing external finance from lending institutions. The SMEs in Embu County are in retail business providing products and services directly to the final consumer. SMEs must also abid to government regulations where they must maintain proper books of account, pay taxes and file returns to K.R.A. Those with salaried employees must observe the statutory deductions before paying their employees monthly salary. Business environment nowadays is very competitive, no single SMEs is exercising monopoly and therefore, a lot efforts must be put in place to enhance competitive advantage (Porter and Kramer, 2002).

1.1.1 Capital Structure

According to Friend (2008), capital structure is a composition of equity and debt capital in a proportion that enhances sound operations of a firm. Capital structure is hence composed of long standing obligations, short-term obligations like bank notes, ordinary and preferred share capital that build up the overall capital of a firm that finances its activities and spearheads growth. In the business balance sheet, the capital structure mostly is placed on the credit side. Capital structure, to a great extent, is composed of the firm's debt and equity (Peavler 2016). Management and owners keeps on making decisions on proportions of debt versus equity as they try get answers to the following questions; so as to get higher returns, should they go for more debts? To reduce risk of high gearing, should the firm use more equity finance?

Seminar work of 2008 by Modigliani and Miller stated that, capital structure is believed to be a factor that influence firms performance in contrast to the position in place. Some of the assumptions that Modigliani and Miller (2008) contends on are the existence of a perfect capital market and expectations that are homogeneous; taxes and
cost of transacting not existing, by considering this therefore there would be no relevance of capital structure to the firm’s value. Hamada (2009) and Stiglitz (2004) has backed this opinion. Consequently, studies by Jensen and Meckling (2006) have disputed the finds made by Modigliani and Miller. Theories on capital structure suggest that, for a rise in value of a firm by way of constraining managers to work more to the good of shareholders there must be a fall in agency cost outside equity by high leverage or low equity/asset ratio (Berger & Bonaccorsi di Patti, 2006). The two major types of liabilities are equity and debt and the holders represent the two classes of firm’s investors. Different levels of risk, gains, and influence have an relationship for each of the two types of liabilities. Though debt owners have no influence over the firm’s operation, they earn fixed rate of interest. This is per terms and conditions of the investment contract. Last category of claimants and who carries nearly all of the risks are the ordinary shareholders despite that, they have greater influence over firm’s decisions (Amit and Schoemaker, 2003).

Among the many decisions accomplished by financial managers the one rated as most significant is on capital structure (Damodaram, 2010). The composition of capital employed can affect the firm’s value and optimality of financing cost. The management core objective is to maximize equity owner’s wealth, cutting cost the minimum and acting within the legal frames governing the establishment of the firm. To ensure minimum cost of capital is maintainable, the determining factor will be an optimum capital structure. Current and prospective investors tend to gather and analyze firms’ information to understand the operations. Agency costs, according to agency theory can be reduced by ownership and optimal capital structure (Jensen & Meckling, 2006). With material data one should expect to see a connection amid ownership structure and capital structure

In this area, empirical studies establish varied outcomes. Crutchley and Jensen (2006), Grier and Zychowicz (2004), Chaganti and Damanpour (2001) and Bathala et al. (2004) noticed unmatching association relating leverage and institutional ownership. In contrast, Chen and Steiner (2009), Berger et al. (2007) and Leland and Pyle (2007) confirms that leverage and organizational ownership have a positive relationship. Also, Ning and Tong (2004) asserts that future financial difficulties may be experienced by
firms with high gearing ratios. Consequently, firms with low gearing ratios will attract institutional investors.

Ratios on capital structure are applied in measuring the leverage: a fraction of total debt to total assets (LEV). To determine the ownership structure of a firm, two variables are used, the natural logarithm of the total shares belonging to Institutional Investors (IO) is first considered, then proportions of institutional proprietorship on subscribed shares is the second, (Tong and Ning, 2004). These indicators thus form an definite (size) measure and a percentage measure, in that order. Use of permanent -cost resources or finances with an aim to boost earnings to the investors results to leverage. Normally, a rise in leverage causes a rise in return and risk, while a fall in leverage causes a fall in risk and return.

Extent of leverage in the capital structure of the firm, equity and long-term debt mix sustained by the firm can considerably influence its worth by having an effect on risk and return (Gitman,2005). Different from some causes of risk, those introduced through use of the leverage can be fully controlled over by the management. At the time of making capital structure decisions, the financial manager need to know how to determine and assess leverage due to how it affect the firm’s value. Referring to the income statement of a firm, the main categories of leverage which are three can are fairly explained. Operating leverage is about the association concerning profits before interest and taxes (PBIT) and sale revenue. Monetary leverage is about the association involving the firm’s PBIT and return to ordinary shares (earnings per share. EPS). Absolute leverage is about the firm’s EPS and sales revenue relationship (Amit & Schoemaker, 2003).

1.1.2 Financial Performance

As an abstract measure, financial performance is how current assets of a firm can be utilized optimumly in the course of normal business activities and raise income for the business (Baxter, 2007). Financial performance is a sign of the financial stability for a given period of time for a firm, and can be used to compare firms in the same line of operations or to compare industries or sectors in total to enable a business plan on how they can improve the conditions at stake with an aim to achieve the business objectives (Berger, Oliver & Pua, 2007). Financial performance can be determined by a number of
ways, though all should be considered as one. Items in the income statement like turnover, inventory levels cost of sales, operating income and expense as well as cashflows from operating activities can be used. Additionally, the analyst or investor may wish to find more from financial statements and seek out margin growth rates or a decline in debt (Brush, Bromiley & Hendrickx, 2000).

Financial and non-financial indicators can be used by a firm to determine its performance. On issues pertaining employees turnover, waiting and delivery time, referral rates on customers and their satisfaction are termed as non-financial measures while sales revenue and earnings before tax are financial measures (Marr, 2008). Acknowledging some problems that may arise by using one measure or the other, entrepreneurs of today have embraced the idea of using both of them. Combining non-financial and financial measures assist in determining the next course of action.

Over the years the performance of Kenyan SMEs has been diminishing. Most of the SMEs that contributed 40% employment in Kenya were closed down due to inability to operate of small enterprise (GOK, 2009). Financial performance of SMEs over the years has been questionable since some have been auctioned and others merged or acquired. From 2001 to 2002, the SMEs performance declined by 56% (Kenya Economic Survey, 2003). Industrial economists also have given a report that small industries have high liquidity risks despite they also enjoy higher growing rate than big industries (OECD, 1997). Due to poor management of short term loan, trade credit and long-term loans, SMEs have continuously experienced some difficulties in improving their financial performance. The cause could be failure by SMEs not using appropriate debts in their normal operations and if this is not dealt with, it might cause financial distress and business failure. (Pindalo, 2006). However, the much availability of debt facilities and the strict procedure of raising the limited available equity finance has caused many SMEs to turn to debt as a source of finance (Githaiga 2015). This fact is theoretically and practically acceptable from the debt providers' perspective owing to the perceived high risk of moral hazard problems among small and medium enterprises. Debt is an important factor for the free flow of cash in the operation of the SMEs.
1.1.3 Capital Structure and Financial Performance

The effect of capital structure on the firm financial performance and total worth is an issue of concern to financial researchers as the conclusive study of (Modigliani & Miller, 1958) refuted any influence in value of a firm by capital structure under competitive market setting. This suggestion tries to say that, the mode of financing real assets does not measure the value of the firm but the real assets themselves are the measure. According to Eldomiaty and Azim (2008) financial performance and capital structure do have a positive relationship. The argument is further supported by Hadlock and James (2002). But, Fama and French (2008) went contrary noting a relationship that is negative. Zeitun & Tian, (2007) believed a strong relation between capital structure and financial performance exists.

According to Jensen and Meckling (2006) there can be a conflict of shareholders and managers caused by high leverage arising from choosing debt, equity or both as investment. Verifiable expectations of these kinds of replicas is a rise in leverage would reduce ownership costs of agency plus debt owners hence enhancing performance of business and to the same extent holding all other constant (Maina, 2014). On the other hand, conflict between equity holders and bond holders can cause a arise in bankruptcy costs or financial distress as a result of increase in debt that is influenced by relatively high limit of leverage. Therefore to differentiate empirically the two causes of agency costs is an uphill task.

1.1.4 SMEs in Embu County, Kenya

The uncertainty in job market in Embu County has called for public policies that tend to award SMEs in the commercial sector conducive term and conditions to raise finance. Lack of adequate information and other risk in lending business has made SMEs experience a lot of constraints in raising the much-needed finance in enhancing their business operations. Inevitably, their capital structure is seriously affected by this (Pettit and Singer, 2005). Raising the required finance is a major hinderance that is encountered by SMEs in the commercial sector all over. From start-up, expansion and growth stages of development, SMEs have difficulties in accessing enough finance due to high cost of raising finance and lack of collateral that financial institution demand (Beyene, 2002). Leasing in Kenya has helped the SMEs to bridge the current financing
gap by providing industrial and commercial equipment’s as it focusses on the ability by lessee’s to generate cashflow from trading operations that can repay the lease rentals rather than on the statement of financial position or credit track records (International Finance Corporation(IFC), 2007; Kisaame, 2007). The requirement will include a lease structure that composes of duration the lease contract, running costs, renewals and incentives.

1.2 Statement of the Problem

Establishing the optimum capital structure in financial management is an important assignment (Pandey 2009). Decisions on capital structure are made while taking into account factors that includes financial performance, liquidity and control. Debt, equity and financial performance relationship is investigated and efforts are made to have the knowledge of how they interrelate. Capital structure is associated with the capacity of the business being to meet the requisites of investors (Boodhoo, 2009). The prior one decade or so has attested substantial transformations in capital structures of businesses (Gomez, 2005). SMEs in the commercial sector are vital to nearly all economies in the world, particularly to those in evolving countries those that their main challenges are employment and income distribution (Omore et al, 2012). Concurring with Elimuti and Kathawala (2009), SMEs promote to the output and creation of “decent” jobs; looking at the dynamic front, they act as start-up for the larger firms of the future, are the following (and critical) step up for expanding micro enterprises, they provide absolutely and often significantly to total savings and investment, and they play part in the development of appropriate technology.

In Africa, there are a small number of researches done on how the capital structure and SMEs performance relate to one another. Though Abor (2005) Studied on the relationship between capital structure and profitability of quoted companies in Nigeria, Kamau (2013) looked at the impact of capital structure on financial performance of errand service SMEs within Nairobi County. Boateng (2004) studied on the determining factor on capital structure in international joint ventures. Nevertheless, not a single study focused on how the capital structure and SMEs performance and more so
on commercial sector irrespective of how they are influenced by financial challenges plus macro-economic factors.

Unlike in big firms where debt-equity ratio has been investigated by a good number of researchers, a few have shown interest on small firms. The financial strategies of big registered companies regularly vary from smaller firms for the reason that, they raise finance through long-term borrowing or issuing equity shares through stock exchange market (Githaiga, 2015). The livelihood of Embu County community is based on agriculture and business oriented activities. Among the major crop that has hit the market is Miraa and a big number of people are in small and medium sized business. According to the K.I.E. Embu branch, most of the SMEs in Embu County have been running their businesses with a lot of difficulties due lack of knowledge on how capital structure can influence financial performance positively and enhance their growth. Most have stagnated and others closed. Quite a good number of these businesses have been raising finance through equity capital, Debt capital and retained earnings. Based on the available information it is obvious that results from the study of the effect of capital structure on financial performance not yet done conclusively and needs further practical work study. No study known to the researcher has been done per se to find out the relationship between SMEs capital structure and financial performance. The study was therefore motivated by this gap in finance knowledge and sought to answer the question. Is there impact of SMEs capital structure decisions on financial performance in Embu County?

1.3 Research Objective

The principal objective of the study was to find out capital structure affects financial performance of SMEs in Embu County, Kenya.

1.3.1 Specific Objectives

The specific objectives of the study were:

(i). To establish the effect of equity capital on financial performance of SMEs in Embu County, Kenya.

(ii). To establish the effect of debt capital on financial performance of SMEs in Embu County, Kenya.
(iii). To determine the effect of retained earnings on financial performance of SMEs in Embu County, Kenya.

1.4 Research Hypotheses

This research sought to test the following null hypotheses:

H₀₁. Equity capital does not have a significant effect on financial performance of SMEs in Embu County, Kenya.

H₀₂. Debt capital does not have a significant effect on financial performance of SMEs in Embu County, Kenya.

H₀₃. Retained earnings do not have a significant effect on financial performance of SMEs in Embu County, Kenya.

1.5 Scope of the Study

The research was conducted in Embu County. For first hand data collection, the respondents were given questionnaires to fill. The purpose of the survey was to establish how capital structure components (equity capital, debt capital and retained earnings) affect financial performance of SMEs in Embu County. The researcher preferred to carry out the study in Embu County due to its competitive advantages in business activities and the notable tremendous growth. The target was SMEs that have been in operation since 2012, having gone through a five years business cycles (2012-2016).

1.6 Significance of the Study

The relationship between capital structure and financial performance is greatly recognized in the financial literature. So as to determine the problems, a study focusing on factors that affect the relationship between capital structure and financial structure was of paramount importance. Today the business environment that SMEs operate in is quite hostile and competitive. Therefore, of great importance, are the research findings available when choosing the optimum capital structure that will enhance a sound financial performance of SMEs. To managers and owners the study will be of benefit as they carry out financial analysis to determine how far the firm has achieved its core objective. It will also promote valuable knowledge to the area of micro-enterprise policy in general.
Study findings on the effect of capital structure on financial performance will equip the managers and owners with relevant knowledge. Also it can further enhance efficient financial policies that will see the firm possess competitive advantage. The research study will aid the SME’s in identifying the factors that influence their financing choices so as to achieve a capital structure that is optimum and can meet needs of diverse stakeholders. Lastly, these study findings will significantly contribute towards the aspect of SMEs financing, capital structure and financial performance.

1.7 Limitations of the Study

The research project faced several constraints which are worth noting. The scholar encountered a challenge on reaching the proprietors due to their busy schedule and geographical locations. However the researcher requested for an appointments that were granted and collected the necessary data. Others not willing give correct information due confidentiality and some of these data were on annual basis, an assumption that the amounts were evenly distributed throughout the year which in reality is not possible. The researcher assured the respondents of confidentiality the data on figures the average figure was used.

1.8 Organization of the Study

Following chapter one that introduces the study, there are other four chapters structured in this respects. Chapter two introduces the literature review, theoretical review, determinants of financial performance, empirical review, summary of literature review and conceptual framework. Chapter three contains research methodology, research design, target population, sampling design, data collection instruments, procedures and analysis as well as ethical considerations. Chapter four presents data analysis, presentation and interpretation. Lastly Chapter five gives the summary, conclusion and recommendation of the study.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Discussions on the theoretical review, empirical review, conceptualization and the research gaps are found in this chapter. First are the capital structure theoretical review and study theories. The chapter also looks into the effects of capital structure on financial performance and analyses that have been obtain from the two concepts. The chapter further reviews empirical evidence on impacts of capital structure on financial performance with the conceptual gaps and an abstract of the literature review.

2.2 Theoretical Review

Among the theories that explain on how capital structure decisions are determined, the three superior theories are pecking-order, trade-off, and agency theories. But a number of study have recommended trade-off and pecking-order theories for privately owned firms that don’t subscribe for external financing. Therefore, the researcher focused on finding out among the two trade-off and pecking-order theories which explains better the capital structure of commercial SMEs.

2.2.1 Pecking Order Theory

Myers and Majluf (1984) recommended the pecking order theory. According to the theory, firms develop an order ranking when it comes to capital required to finance business operations. Due to lack of adequate information and a good link between future investors and firms, the preference will be as follows; debt better than equity, retained profit preferred to debt, and short term loan superior than long-term loans.. Myers and Majluf (1984) maintained that to resolve information asymmetry firms wouldn’t require to issue new securities but instead use retained profit to support investment opportunities. This shows by raising ordinary share capital will be costly as outsiders and insiders on asymmetric information increase. To prevent selling understated securities, firms with considerable information asymmetry should go for debt. Issue of new common stock is one of the capital structure scenarios that can cause decline in stock price.
The pecking-order theory depends on the idea of asymmetric information involving outsiders (investors) and insiders (managers), this helps managers in selecting the best source of finance. This theory argues that, sources with the minimum levels of asymmetric information attracts firms requiring funding since the borrowing expenses increases with this metric. Myers (1984) claims that, retained earnings are better than debt and debt is better than equity when selection is done unfavorably. The adverse selection model influenced the ranking, according to Myers and Majluf’s (1984). On the other hand, a variety of sources including taxes and agency conflicts have stemmed the ranking.

Pecking Order Theory suggests that, bigger size lets a firm to accumulate retained earnings, and so smaller amount of debt is necessary. Consequently, Pecking Order Theory forecasts an adverse correlation between size and debt (López-Gracia, Sogorb-Mira 2008). According to Myers (1984), bigger firm size lowers the problems of information asymmetry among the managers/owners and creditors, allowing firms to get debt on more good terms. The correlation between size and debt can either be positive or negative, Pecking Order Theory suggests. For the intention of this study, theory on Pecking Order is of paramount importance as is intended for the assessment of financing performance of the SMEs along the life cycle. According to Pecking Order assumption, older firms have a superior ability to retain and accumulate earnings, and so the demand to go for external financing to solve their financing needs will be less than in the situation of younger SMEs. The possibility of old SMEs reserving profits over time is significant, so the older SMEs lessen the alternative to borrowing.

2.2.2 Trade-Off Theory

This theory came from the research done by Kraus and Litzenberger (1973), who properly initiated the tax benefit related to borrowed finance and financial distress costs into a state preference model. This theory suggested that, balancing of cost and benefits are the main factors in deciding the amount of borrowed fund and owners’ equity to use. The offsetting of benefits against costs of debt in capital structure is well addressed by trade-off theory. It deliberates on the numerous corporate finance options that a corporation encounters. According to the theory debts and equity capital are normally
the two sources of finance to a firm. Agency and distress costs in capital structure are the two concepts that are mainly dealt with by Trade-off theory. (Penman, 2001).

Capital structure Trade-off theory is of significance in explaining that firms total capital composes of part equity and debt forms the other part. According to the theory, debt finance has an advantage of tax on interest though there is floatation cost, also non-bankruptcy and bankruptcy costs that forms financial distress costs. (e.g. labor turnover, unfavorable credit terms from suppliers, conflict between shareholders and creditors etc). The minimal gain of additional long-term fund drops as it rises, whereas the minimal cost rises, thus a firm enhancing its total worth focuses on this counterbalancing at the time of deciding how much to raise from each source (Makanga, 2015). Focusing on the trade-off theory the optimal capital mix would occur where there is a counterbalance between tax benefit and marginal costs related to bankruptcy. Consequently, debt would be more preferred to equity by firms up to a point where cost of bankruptcy starts to be significant.

According to Brigham & Ehrhardt (2005) trade-off theory suggests that the unlevered firm value together with the cost of side effects arising from tax shield and cost from financial distress. The possibility of bankruptcy is low and immaterial to a firm that has not been financed by debt or low debt financing. Baxter (2007) maintained that, a massive usage of long-term fund raises the likelihoods of firm experiencing liquidity problems and hence ask for an additional premium to cover the risks. A further recommendation to the firms was that, they should not use long-term fund to a level that the debt costs exceed the tax shield benefit. The tax shield benefit may be reduced by an increase in anticipated cost of bankruptcy due to rise in long-term financing. This theory is valuable for this analysis because firms assess borrowing costs alongside the advantages of long-term financing. Costs of bankruptcy and paid interest makes the borrowing cost. Advantages of long-term financing are the allowance of interest paid from tax and the management self-control out the terms and conditions of the financing.
2.2.3 Agency Theory

Jensen and Meckling (1976) developed the theory. The focal point is on the behavioral association among the owners (principals) and those others (agents) who are contracted by the owners to execute duties on behalf of the principal. The theory of agency focusses on the perception that shareholders’ interests are not among the priorities of the managers. Jensen and Meckling (1976) further go into detail on this concept by recognizing two foremost conflicts between parties to a company, firstly, shareholders disagrees with owners, and secondly, owners differ with the creditors. In the first case, managers are enticed to pursue the profits of the firms they oversee to their own individual gain at the disadvantage of the shareholders. In the latter case, debt imparts shareholders with the enticement to invest sub-optimally.

Managers may perhaps avoid extreme level of leverage if they sense that, it puts their jobs and income at stake. Alternatively, shareholders, can spread company certain risks, prefer riskier projects. Neilson, (2004) submits that management might recommend a projects whose net present value is positive and the gain mainly go to bondholders. According to Smith and Warner (2009) dilution of claim and asset substitution can cause more agency conflicts amongst shareholders and bondholders. Corporate and financing policy choices can pose incentive to a number of claimants that will lessen value-reducing behavior and henceforth lower agency costs.

Comba (2013) asserts that by increasing reliance in debt financing can help firms in lowering their agency costs. The demand for financing through owners’ equity reduces together with related agency costs. Nevertheless, a corporation’s capability to progressively depend on long-term funding is restrained owing to debts high agency costs ensuing from the likelihood of the firm dwindling into financial distress. Additionally, to financial distress costs, present shareholders can be diluted by the extra debt holders claim and consequently demand higher returns that are replicated in the firm's cost of capital that is high. This theory is imperative for this survey because, the choice of dividends, leverage and management ownership can alleviate costs of agency resulting from firm's contract relationship. The managers of SMEs can raise their stake of ownership in the firm and bring into line their interests with those of shareholders, ensuing in a coming together of interests among shareholders and managers. Even by
enhancing the firm equity share, the diversification of individual portfolio is lowered by the management.

2.3 Determinants of Financial Performance in SMEs

The financial formation of an organization and its capability to settle its obligations on time is influenced by cash flow Leverage and liquidity. For each of the three types of measures link to a distinct element of this attribute of firms operation. The organization financial structure is explained by leverage measures that incorporates debt to total assets, times interest earned and debt to equity (Subrahmaniyam 2009). The interval measure, current ratio and quick ratio which are all measures of liquidity can be used assess the ability of organization to convert assets into cash. Lastly, measures of cashflow explains the organization cash in total that is generated and where it comes from comparatively to the cash demands of the organization measured through cashflow to assets and equity (Dobbins and Barnard, 2010).

2.3.1 Leverage

The financial formation of the firm is measured by use of leverage ratios. The extent to which the current assets are financed by borrowed fund as compared to owners fund is the financial leverage (Penman, 2001). Regular honor of loan repayment plus interest is what entails the debts agreements. Ordinary shareholders instead, have no obligatory call to be paid returns either periodically or at the time of termination of the firm business. As a result, holders of debt get an inflexible return whereas ordinary shareholders get the remaining once all interested parties are satisfied (Berger & Udell, 2008).

Consequently, if the profits earned by the firm exceed cost of debt, the extent of that surplus profits over cost of debt finance turns out to be enjoyed by the ordinary shareholders. A firm that is not able to make profits that is more than cost of debt finance, the ordinary shareholders earn no return but debt holders continue to earn their fixed rate of return. (Robert, 2006). Owners have high chance of losses and gains when there is high debt equity ratio. This connection is usually known to be a trade-off of gains and losses to firm owners. When the leverage of a firm is high, the higher the chance of bankruptcy in bad seasons, and on the other hand, during good times the
chances of high profits to be enjoyed by equity capital providers is high (Sandberg et al, 2012).

2.3.2 Liquidity

Means the firm’s being in a position to pay the required amount of borrowed fund when time to pay is due. In principle, the assets of a company are said to be liquid if they can be converted into cash within a relatively short period without loss in value (Brealey, et al., 2001). Whether the business is gaining more capital to ensure smooth running of its activities without endangering its liquidity position is the significance performance issue. In view of that, liquidity measures denote one side of an element of entire organizational performance, though inadequate indicators that can signify a complete concept. Together, absolute and percentage terms can be used to measure liquidity (Subrahmaniyam 2009). Working capital which is an excess of current asset over current liability is a good measure of organization liquidity. The period of time that a firm can do its trading transactions by utilizing assets that are liquid and not effecting some more sales can also be used as an interval to measure liquidity. Acid test ratio, current ratio and working capital changes are some of the percentage liquidity measures (Githaiga & Kabiru, 2014).

Terms and conditions of debts contract together with other debts requirements are not shown by computation from financial statements which therefore indicate a crucial weakness on measures of liquidity (Campel 2009). Normally, cost of debt is higher than what investment on short-term can earn, a good business practice will be to use all cash that is in excess in reducing interest-earning current liabilities given that current arrangement on borrowing can be replaced within shortest time possible (Koeter, 2008). Real liquidity can be underreported by firms financial statements due to inability to report liquidity in excess arising from organization current arrangement on borrowing that enhance access to capital.

2.3.3 Cash Flow

Apart from meeting current obligations, cashflows can also be used to measure the ability of the firm to pay contributors of capital some return. Finally, the financial advantage or worth, that is attained from a firm is influenced by the cash payment
obtained by resource providers. Copeland, et al.(2000); West and Jones (2009) maintains that, the cashflow that is anticipated and the cash payout timing by investors are the usual business valuation approaches. Cashflow is the current determining factor of the firm’s value. For this reason, the cashflow accessible by investors can therefore be measured as part of firm’s performance. However, the changes of application and sources of cash due to investment opportunities and rates of growth year after year puts the researcher on need to understand when cashflows is to be measured.

Brealey (2001) theorized measures of cash flow to include cash flow as a percentage on return on equity, percentage on return on assets, net cash flow from operations and the growth rate of operating cash flows. Every measures here deals with the cash available to the organization that enables it to acquire the fund required for the financing and investment activities.

2.4 Empirical Review

Bhaduri (2002) researched on European poultry states to find out how capital structure is influenced by business risk and found that business risk is among the key factor that has influence on firms capital structure. From the study he established that debt is about honoring payments done on regular basis, firm with high debt equity ratio may have difficulties in meeting financial obligations to their creditors leading to related costs like expensive financing, opportunity costs etc. As a result, firms that have volatile incomes tend to be lowly geared. The relationship between business risk and capital structure is therefore negative. Businesses with low risk attracts institutional investors since firms whose their return is highly volatile has high chance of defaulting and becoming bankrupt. This therefore, results to a relationship that is negative between firm’s institutional ownership and business risk.

Myers and Majluf (2004) studied the effect of asymmetric information on firm’s when choosing the best finance source. A descriptive study was conducted in Canada with a sample of 342 agribusiness organizations. According to the study availability of information that is asymmetric would make a prefer internal finance over other sources of funds, but after utilizing all the internal fund it would turn to borrowing, issuing new equity as a source of finance may be the last alternative, profitable firms usually have more retained earnings.
Donaldson, (2001) sampled 235 consultancy firms in Canada to study how past profitability and leverage influence one another. According to the study there could be a negative relationship between past profitability and financial leverage. Conclusion from the study was that, firms that are profitable will be preferred by investors. The fact is that, firms that are profitable tend to have lower risk of bankruptcy and may fail to meet its financial obligation due to absence or minimal financial challenges. A relationship between institutional ownership and profitability is therefore expected to be positive.

Hovakimian et al. (2004) involved 312 firms to investigated the impact of growth potential of dairy firms to investors in UK, applying exploratory research design he established that, more capital gains resulting from high growth dairy firms brought to institutional investors than lower growth ones, agency problems are likely to be more harsh for growing firms, this is due to availability of various future investment that they can choose. Therefore, there exists a negative relationship between long-term leverage and growth rate. Furthermore, organizations future performance may be provided as a possible indicator to show firms that have high growth prospects. Thus institutional investors would go for high-growth firms instead lower ones. The conclusion was that, established stockholders, as major contributors to KRA would avoid double tax by investing in stock that generate capital gain so as to defer payment of tax. Hence, the established investors would consider opportunities of a firm’s growth as a positive signal.

Rajan and Zingales (2005) carried a research on G-7 nations to establish how the size of a firm influences the formation of capital employed, sample of 21 small and 21 big businesses were considered and used to assess the two groups findings and established a wider diversification in large firms and hence less likelihood of default. Rajan and Zingales (2005) supports the projections of balancing costs and benefits theory (trade-off) which recommends, big firms need more borrowing due to their enhanced diversification that reduces their bankruptcy rate and experience minimal bankruptcy costs. Likewise, big firms also have lesser agency costs of debt, for instance, comparatively lesser monitoring costs for the reason that there is less volatility in cash
flow and easy access to capital markets. From the results the conclusion was that between the firm size and leverage the relationship is positive.

Miller and Rock (2005), John and Williams (2005) evaluated roles played by corporate status when enlisting in the equity market by service industries where explorative was applied with 231 questionnaires and a 45% response rate. The findings from the study were, a firm with a good corporate reputation arising from paying constant rate of dividends experience less asymmetric information when getting into equity market. Therefore, if dividend payments signifies stable financial status and hence higher borrowing capacity, most probably there will be a correlation that is positive between leverage and divided payment. Furthermore, capital markets will monitor firms that have a reputation arising from paying a stream of dividends. Institutional ownership can perform as an another method for doing an evaluation hence minimizing the requisite for external monitoring practice like capital markets. The investigation established that there exists a relationship amid institutional ownership and dividend payments that is positive. Nevertheless, the presence of institutional ownership alleviates the requisite for dividends as an indicator of good performance.

A study carried by Myers and Rajan (2008) in German banking sector aimed at finding out how liquidity is influenced by agency cost. It discovered that when borrowing exceeds creditors threshold there exists a negative relationship. As a result, liquidity and borrowed fund relationship is expected to be negative. Equally, to the established investors, the impact of convertible assets is unclear indicator. A liquidity ratio that is high is thought to have negative sign since it shows firm encountering difficulties as regards opportunities for its long-term investment decisions. Thus for institutional investors, a high liquidity ratio may be considered to be a negative signal. Since the firm is able to meet its financial obligation when they fall due and hence lower default risks, a high liquidity ratio can therefore be considered to be a positive signal. Therefore, for established investors high-level of liquidity is expected to be a positive indicator.

Ebaid (2009) examined how the choice of components of capital structure influences the firms performance in Egypt. Gross profit margin, Return on asset and equity were used evaluate performance. Capital structure was assessed by comparing current
liabilities assets asset, long-term fund against asset, and debts to assets ratio. Relationship between performance and leverage was established by use of Multiple regression analysis. It revealed an insignificant effect of capital structure on the firms' performance. A research done in Kenyan pharmaceutical industries to find out how the capital structure influenced the performance, Adekunle (2009) compared debt against equity as an alternative to capital formation whereas ROE and ROA were used to assess the performance of firms. Ordinary Least Squares method of approximation was applied in the study. A study on how measures of financial performance are influenced by debt equity ratio revealed a significant negative effect. On the other hand, the study didn’t take into account other financing decisions in the evaluation, even the intervening impact of the internally available cash flow.

During the period between 2004 and 2008, Kaumbuthu (2011) tried to establish the relationship of industrial return on equity to capital structure and related sectors in the Nairobi stock market. Performance focused on return on equity while composition of capital took the place of debt equity ratio. By using the regression analysis to establish the influence of debt equity to return on equity ratio, a negative relationship was found. Investigation focused on only one sector of the companies quoted in Nairobi Securities Exchange and gave consideration to only one aspect of financing decisions. Therefore, these study findings cannot be generalized to include some other more sectors. To establish the effects of firms decisions on financing to financial performance, non-financial firms quoted in the Nairobi stock market were all included by the current thesis.

On the impact of capital structure to financial performance of quoted companies in the Tehran Security markets was further carried out by Saeedi and Mahmoodi (2011). The study revealed a positive correlation between performance market measures and capital structure while between return on asset and capital structure the relationship is positive but on return on equity and capital structure no notable relationship. According to Mahmoodi and Saeedi (2011) findings, different measures of performance may be affected by financial leverage.
2.5 Summary of Literature Review

The chapter has looked at the theoretical review and empirical review. The researcher in theoretical review, looked at the theories which act as the study foundation. The emphasis was paid to the pecking-order, cost/benefit set-off (trade-off) and agency theories by the study since they appropriately give explanation of the capital structure and ownership as determinants for firm performance. Among the contributions from the theories, the major contribution is that, cost of external equity is lowered by low equity/asset ratio or high gearing and by making managers work further towards shareholders’ interest raises the value of the firm. For that reason capital structure is believed to have an influence on a firm performance. The empirical review focus on factors of capital structure; SMEs performance and capital structure. The preceding literature review on financing SMEs admits that, in particular, maturity of debts and capital structure in general, up to date, no tool to deal with them has been put in place: unique features of SMEs are not contained by models that are theoretical; what is provided empirically is only past explanation instead of finding out how to establish an optimum capital structure. Provided we can establish from the existing literature, realistically there is no a provided way that can assist SMEs in optimizing there capital structure.

2.6 Conceptual Framework

A conceptual framework according this study refers to an established extensive plan and assumption/rules gotten from an appropriate discipline enquiring how to structure a successive presentation (Bundi, 2002). As a tool applied in research, it’s expected to aid the researcher build a perception and familiarity with the condition being scrutinized and reveal it. Figure 2.1 of the conceptual framework shows the relationship between dependent variable (financial performance of SMEs) and independent variables (equity capital, retained earnings, term loans/borrowings and cost of production).
Independent Variables

Equity Capital is contributed by the real owners of a business; it is permanent source of finance. The shareholder bears the greatest risk in business operations. If the profits are low the shareholder will suffer as they will be paid divided from profit after the payment of interest on loan and taxation. Similarly, in winding up, the equity holders will get paid last. On the other hand, if a company’s profits are very high then the equity holders will benefit more. On financial performance, the equity holder will be interested on getting the maximum net income that will encourage him to add more to enhance growth and expandability of the firm. With good financial performance, there is positive effect towards market value of the equity shares. This boosts the asset base due availability of finance. Also improves the level of working capital resulting ability to short term and long-term obligations as they fall due. It also lowers the gearing ratio minimizing liquidity risks.
Debt capital is the borrowed fund from a financial lending institution. Companies borrow and normally repay with an interest in future. The lenders of debts capital do not become owners of the firm but instead receive contractual fixed amount of money that include principle and interest at a fixed rate, are just creditors and suppliers of debt finance though at times they can appoint a representative in board of directors to look at their welfare. When it comes to repayment of returns to financiers, debt is ranked above equity capital. This means debt interest must be paid in full first before equity owners get dividends. A highly geared company may have problems in paying dividends especially if business operations are unfavorable. Debt capital improves financial performance especially when equity capital is not enough to purchase fixed assets of the firm. Definitely this improves financial performance. Retained earnings, the undistributed part of profits which belong to the ordinary shareholders not paid out to them in the period they are earned. It forms the most important source of fund for expansion because it is the cheapest and painless method of raising additional capital. The retained earnings can be used to expand the business improve its asset base and improve the liquidity, this will facilitate the act of performing financial activities.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The study has been completed by following a number of phases and stages which are outlined in this chapter. The plan comprised of data assembling, measurement and evaluation. At this stage, most decisions about how research was executed and how respondents were approached, as well as when, where and how the research was completed is well emphasized. As a result, in this section the research identified the procedures and techniques that were used in the collection, processing and analysis of data. In particular, the following subsections were included; research design, target population, sampling design, data collection instruments, data collection procedures and finally data analysis.

3.2 Research Design

The study adopted the causal research design. According to Cooper and Schindler (2006), a causal study is meant to determine the impact of one variable(s) on the other variable(s) which describes relationship. Causal research is by and large designed clearly with specified objective to find out relationships and causal relations amongst distinct variables. The design was recognized as a suitable tool to carry this study since it entails assembling, confirmation, and synthesis of confirmation to verify facts that support or disprove a belief. According to cheng (2014), design entails use of data from secondary sources. was obtained from sources such as Financial statements, archives, official records and reports were the main source of Secondary data. The past documentations can be of valuable importance background that is needed so as to comprehend more fully and explain the research problem. Throughout the study, there was no possibility of researcher-subject interaction that could influence the findings and hence the design was very useful. So as to study different research problems or to replicate a previous study, historical sources could also be used over and over (Cooper & Schindler, 2006).
3.3 Target population

Is the whole group of elements or objects which researchers wants to study and make general conclusions. The target population usually has varying characteristics and it is also known as the theoretical population. According to Ngechu (2004), a target population is a distinct or determined group of objects, people, services, elements, events, things or households that are under study. Agreeing to the definition therefore a target population of interest should be homogeneous. Target population studies are an enhanced representation since all members have equal chance to be counted in the final sample that is obtained according to Bryman (2006). Kothari (2004) explains target population as the sum total of constituents about which conclusions are to be made. Therefore, the group that is made of all probable interpretations of a traits of concern is the population under study, while a collected works of observations representing only a unit of that population is a sample (Denscombe, 2008). The study targeted SMEs in Embu County, Kenya. The SMEs targeted are those in retail business selling products and services directly to individual consumers for their own use with a goal of earning a profit.

3.4 Sampling Design

Sampling refers to a procedure of selecting some members to be studied as they represent the large group from which they are selected (Oguia, 2005). Stratified random sampling method was used to single out SME’s for the survey whereas purposive sampling was used to select respondents who were to fill the questionnaires. It made it possible for all the enterprises in all the categories to stand equal chances of being incorporated in the sample (Singleton et al., 1988). Stratified random sampling entails subdividing the population into mutually exclusive parts called strata, based on the categories of one or a combination of relevant variables. From each stratum a simple random sample is then drawn and these sub samples are put together to form a complete stratified sample (Singleton et al., 1988).

A sample of 29 SMEs from the target population of 95 SMEs in Embu County was selected for the investigation, depending on the size of each stratum. This represented 30% of the total population. Mugenda and Mugenda (2003) advocates for a sample size of between 10% and 30% this is considered appropriate and representative of the total
target population. From each stratum, purposive sampling was used to select two respondents from each sampled SME (a manager and proprietor), thus totaling to 58 respondents.

Table 3.1: Sampling

<table>
<thead>
<tr>
<th>Category of Respondents</th>
<th>Target Population (for SME’S)</th>
<th>Sample Size (for SME’S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boda-boda Industry</td>
<td>30</td>
<td>9</td>
</tr>
<tr>
<td>Motor Vehicle Industry</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Clothing Industry</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Fruits and Cereal sellers</td>
<td>20</td>
<td>6</td>
</tr>
<tr>
<td>Stationery shops</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Pharmacies</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Mobile phone Industry</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td><strong>95</strong></td>
<td><strong>29</strong></td>
</tr>
</tbody>
</table>

Source: County Trade and licensing office, 2017.

The total sample size for SME’s was 29. From each SME business, the respondents were two (manager and Proprietor) making a total of 58. Questionnaires copies were 58 just like expected respondents.

3.5 Data Collection Instrument

This research utilized both secondary and primary. Annual reports from firms acted as source for secondary data. A period of five years was preferred which was from 2012 to 2016. The data was mainly extracted financial statements. Organization statements and newsletters were reviewed by the investigator so as to get firms secondary data on capital formation of these organizations. Questionnaires that were designed with
unstructured and structured questions enabled the collection of primary data. According to Cooper & Schindler (2006) a questionnaire outlines the problem and specific objectives of the study.

3.6 Data Collection Procedure

The researcher administered the questionnaires personally to all respondents. A questionnaire is research tool comprising of a number of questions and other prompts meant to gather information from respondents. Requires less effort and time from the questioner unlike telephone surveys or verbal and often have standardized answers that make it easy for the researcher to compile data (Zhenyu Du 2012). The questionnaires were administered by delivering and collecting afterward to the selected respondents. According to Cooper and Schindler (2006) the use of the Drop-Off/Pick-Up (DOPU) technique lead to a significant high response rates. Furthermore, the DO/PU as method reduces effectively possible non-response arising from bias through increased response rate. The researcher prepared an introduction letter that stated the study purpose and sent to the manager/proprietor. Moreover, the purpose of the study was further explained to the individual respondents through telephone calls and also requesting for financial statements. High level of confidentiality was also guaranteed. This enhanced integrity in collected data.

3.7 Validity and Reliability

This section explores validity and reliability tests conducted on the research instruments.

3.7.1 Validity

Research instruments are supposed to measure accurately and specifically what they are intended to measure. Mugenda (2003) describes validity as the accurateness and relevance of inferences, which are founded on the research outcomes. It’s the point at which outcomes gotten from the evaluation of the data truly signify the observable fact under study. The researcher relied on external validity. The content validity was determined by giving the questionnaires to the experts who vetted the items. To achieve this, the questionnaires was given to three lecturers from the department of Accounting and Finance knowledgeable in the area to vet on the items used in the questionnaire.
The researcher also made corrections according to the supervisor’s guidelines and ensured that the questions were in accordance to the study objectives.

### 3.7.2 Reliability

Reliability is the extent to which a research instrument can give similar results after carrying out a given trial again and again. The point at which the results are free from unintentional incidents of the research (kirk and Miller 1986). A reliability coefficient of 0.6 and above is up to standard. A Cronbach Alpha of less than 0.6 signifies that, the questionnaire reliability is too low hence need to amend the data collection instrument. To ascertain the magnitude to which the research tool is reliable in evaluating the factors under study, a tests on reliability was conducted to assesses on security and liquidity availability.

### 3.8 Data Analysis and Presentation

This is a process used to make sense of the data. SPSS version 20 software of data analysis, was applied to examine the quantifiable data. Further, an analyzes of quantitative data was done through use inferential and descriptive statistics. Descriptive analysis (means and Standard deviations), correlation analysis as well as Multiple Regression Analysis methods of data analyzes were used. Figures and Tables were used in presentation of Quantitative data. The study also used qualitative data attained from questions that were open ended. The presentation of data was then done in a prose form.

\[
Y = B_0 + B_1X_1 + B_2X_2 + B_3X_3 + \epsilon
\]

Where

- \( y \) = Financial Performance
- \( B_0 \) = Intercept
- \( X_1 \) = Equity Capital
- \( X_2 \) = Debt Capital
- \( X_3 \) = Retained Earnings
- \( B_1-B_3 \) = Regression Coefficients
- \( \epsilon \) = Error Term
3.9 Ethical Considerations

Ethics are standards for conduct that differentiate between acceptable and unacceptable behavior (Resnik, 2015) Ethics has got to do with the respect to the dignity and integrity of the respondents with respect to the information gathered. The researcher ensured there was a high ethical standard by maintaining the integrity and dignity of the respondents. This was done by ensuring that all the questionnaires do not have items that may cause anxiety and discomfort among the respondents. The researcher also conducted himself well by ensuring that he had courtesy to his respondents. There was no room for deception and the researcher revealed the full intention of the research to the respondent.
CHAPTER FOUR
DATA ANALYSIS AND PRESENTATION

4.1 Introduction

This chapter presents the data analysis, presentations and interpretations of the findings on relationship between capital structure and financial performance of SMEs with reference to Embu County. Collected data is tabulated using tables and pie charts and then analyzed using descriptive statistics, ANOVA, Pearson’s correlation coefficients and multiple linear regression analysis. The chapter captures study findings, analysis and results from data that has been collected by use of questionnaires. 58 questionnaires were issued to the sampled respondents, 42 (72.4%) were fully filled and collected. Statistical Package for Social Sciences (SPSS) version 20 was used to analyze data. Descriptive statistics (means, standard deviation, variances, kurtosis and skewness) presented data in a manageable form so as to describe features of the collected data in the study. Also some tests that included multicollinearity, heteroscedastic and normality were carried to test the correlation between the independent variables (equity capital, debt capital and retained earnings) that showed there was no interdependence on the variable. On the predictor model, multiple regression analysis was carried out between dependent and independent variables. The model was found to of good fit. The chapter provides answers to the research questions and provides a basis for confirmation of relationships and conclusions.

4.2 Response Rate

The researcher dropped 58 questionnaires to the sampled respondents but only picked 42 questionnaires, which were fully responded to giving an approximately 72%. 42 respondents (72%) was deemed satisfactory for the study and for generalization of the findings. Conversely, 16 respondents (28%) did not return their questionnaires. The high response is attributable to collaboration and enthusiasm by the respondents to take part in the study and adequate groundwork by the researcher.
The table below shows the results obtained.

<table>
<thead>
<tr>
<th>Category</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Questionnaires returned</td>
<td>42</td>
<td>72%</td>
</tr>
<tr>
<td>Questionnaires not returned</td>
<td>16</td>
<td>28%</td>
</tr>
<tr>
<td>Total</td>
<td>58</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

4.3 Validity and Reliability Test Results.
The test aimed at validating the questionnaires on SMEs capital structure and financial performance. The researcher used the Cronbach Alpha Coefficients to test validity and reliability which yielded an Alpha Coefficient of 0.951, an indication that the instruments was reliable for the study

4.4 General Information
The general information of the SMEs were analyzed and tabulated. This entails the gender, need for financial services, liquidity position, financial management skills and whether the SME achieves the objective of maximizing profit.

4.4.1 Year of Establishment
The researcher sought find out how long the SME has been in the business. The study results are in the table 4.2 below.
Table 4.2 Year of Establishment

<table>
<thead>
<tr>
<th>Year of establishment</th>
<th>Frequency</th>
<th>Percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>3</td>
<td>7.2</td>
</tr>
<tr>
<td>2015</td>
<td>4</td>
<td>9.5</td>
</tr>
<tr>
<td>2014</td>
<td>5</td>
<td>11.9</td>
</tr>
<tr>
<td>2013</td>
<td>4</td>
<td>9.5</td>
</tr>
<tr>
<td>2012</td>
<td>6</td>
<td>14.3</td>
</tr>
<tr>
<td>Before 2012</td>
<td>20</td>
<td>47.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>42</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Research data, 2017

Table 4.2 shows 47.6% of the SMEs started to operate before year 2012. This shows a good number of the respondents had acquired good knowledge and experience in the business and have been able to overcome business cycle challenges over the past five years.

4.4.2 Gender of the Respondents

The researcher sought to establish the respondent’s gender by ask them to indicate by using a tick. 67% of the respondents were male while 33% were female. The study results shows most of respondents were male even though female respondents were adequately represented.

4.4.3 Financial Advisory Services

The researcher sought to establish whether the respondents ever seek the financial advice when running the business. The results were as follows
According to figure 4.3, 59.52% of the respondents never go for financial advice whereas 40.48% seek financial advice from experts. These results indicate that most of the small and medium enterprises in Embu County are run by sole financial mind and thus financial move totally relies on the owner decision.

4.4.4 Liquidity Position

The researcher sought to find out whether the SMEs in Embu county were in stable liquidity position.

Table 4.3 Liquidity Position

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>37</td>
<td>88.1</td>
<td>88.1</td>
<td>88.1</td>
</tr>
<tr>
<td>no</td>
<td>5</td>
<td>11.9</td>
<td>11.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>42</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Research data, 2017

Table 4.3 above shows that, 88.1% of the SMEs were in a stable liquid position while 11.9% were not. This shows the reason why there has been a tremendous growth in SMEs in Embu County.
4.4.5 Financial Skills

The researcher aimed at establishing the financial skills of the respondents in operating and running the firm. The outcome however displayed a very interesting statistic where the population showed equal. The results were as follows

Table 4.4 Finance Management Skills Statistics.

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>21</td>
<td>50.0</td>
<td>50.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Valid</td>
<td>no</td>
<td>21</td>
<td>50.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>42</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

The above table 4.4 shows how responses were received on whether they go for financial management skills. The number of those who seek financial advice was 21 (50%) and those who does not seek financial advice was 21 (50%). The study shows half of the SMEs are equipped with business management skills and is the reason why a good number tends to excel despite being small in size while others seems to struggle in their business activities.

4.4.6 Profit Maximization

The study sought to find out if the SMEs do realize their goal in making profit in their business activities. The results obtained were as shown in table 4.3.

Table 4.5 Profit Maximization

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>40</td>
<td>95.2</td>
</tr>
<tr>
<td>No</td>
<td>2</td>
<td>4.8</td>
</tr>
<tr>
<td>Total</td>
<td>42</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

Table 4.5 study findings reveals that, majority (95.2%) of SMEs do make profits in their business activities. This has made them to remain in business. Most of SMEs have no any other source of income and depends on their business for their living. With
95.5% being able to make profit, this shows the reason why there has been tremendous growth of SMEs in Embu County.

### 4.4.7 Source of Equity Capital

The researcher sought to establish where the respondents got their equity capital and gave various options like, personal savings, farming, employment and family support.

**Table 4.6 Source of Equity Capital**

<table>
<thead>
<tr>
<th>Source of Equity Capital</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Farming</td>
<td>11</td>
<td>26.2</td>
<td>26.2</td>
<td>26.2</td>
</tr>
<tr>
<td>Saving</td>
<td>9</td>
<td>21.4</td>
<td>21.4</td>
<td>47.6</td>
</tr>
<tr>
<td>Employment</td>
<td>16</td>
<td>38.1</td>
<td>38.1</td>
<td>85.7</td>
</tr>
<tr>
<td>Family support</td>
<td>6</td>
<td>14.3</td>
<td>14.3</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>42</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Research data, 2017*

Table 4.6 results above showed that, majority of the respondents got their equity capital from employment with a thirty-eight percent followed by farming with twenty six percent. The farming was anticipated by the researcher since Embu is tea farming zone which is considered to be the best paying cash crop country wide. This indicates that, some SMEs were employed and either resigned or retrenched and the money earned during employment was used as capital to start the business. Others did some farming and were able to get a startup capital

### 4.5 Descriptive Analysis

At the time of study the researcher applied descriptive analysis to enhance description of the raw data. The raw data was transformed into a form that made it easy to understand and interpret by rearranging, ordering and manipulating data to generate descriptive information. Descriptive statistics were extracted through, SPSS Version 20, for purpose describing and comparing the variables under study. Tables were used to enhance understandability.
4.5.1 Equity Capital

Equity capital according to this study refers to the finances/resources brought into the business by the owner. It is risk free and is not refundable to the owner in the normal course of business. It’s a permanent source of finance. The study sought to establish the familiarity of the SMEs as regards the equity capital. A set of eight items were used. The findings based on a Likert scale rating, where 1 was strongly Disagree and 5 was Strongly Agree were summarized in Table 4.7 below.

<table>
<thead>
<tr>
<th>Statement</th>
<th>N</th>
<th>Range Minimum</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>SME relies on equity capital to run</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.69</td>
<td>.227</td>
<td>1.473</td>
</tr>
<tr>
<td>SME has less liability burden</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.98</td>
<td>.217</td>
<td>1.405</td>
</tr>
<tr>
<td>Equity preferred to loan since is cheaper reserves are maintained to</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>3.50</td>
<td>.244</td>
<td>1.581</td>
</tr>
<tr>
<td>ensure continuity equity capital has advantages than all</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.31</td>
<td>.254</td>
<td>1.645</td>
</tr>
<tr>
<td>Equity capital alone is enough to finance a business</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.98</td>
<td>.254</td>
<td>1.645</td>
</tr>
<tr>
<td>Members receive flexible dividends from savings firm minimizes average</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>3.30</td>
<td>.259</td>
<td>1.736</td>
</tr>
<tr>
<td>cost of capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>42</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research data, 2017

From table 4.7 above, the highest scoring item had a mean of 3.50 while the lowest mean score was 2.31. The distribution of the means is normally distributed. Overall, the average score for equity capital familiarity appears to be average and hence there is need to put more emphasis on how to raise and increase to a level that it commands largest share in capital structure. According to the Likert scale, score of 5 indicated
strongly agree, 4 agree, 3 neutral, 2 agree and 1 strongly disagree. Hence, results in Table 4.7 indicate that most of the respondents were in agreement or neutral or disagreed to the selected items on equity capital.

The study also found that majority of the respondents agreed with the statement that; equity capital is preferred to debt equity since it is cheaper, members receive flexible dividends from their savings and with the use of equity, firms minimizes the weighted average cost of capital. Moreover, the respondents were neutral many of the attributes, this means they were neither agreeing nor disagreeing. This aspect therefore calls need for further analysis. The study findings shows that equity capital is highly recognized as major source of finance, this is due to the fact an item on; equity capital alone is enough to finance a business scored average. On whether the equity capital is maximum majority said “NO”, this shows the SMEs preferred to wait as they hope to develop a way to raise more equity capital instead of going for debt capital or retained earnings

4.5.2 Debt Capital

According to this study, debt capital refers to the amount of money that owner borrows and has to repay the principle amount plus the interest. It earns a fixed rate of interest which must be paid whether the business makes profit or loss. It can either be short-term or long-term. A lot of debts is dangerous to the business. The study found that majority of SMEs prefer short-term debts. To establish the extent to which the SMEs appreciates the usage of debt capital, to determine the knowhow and usability of debt capital by SMEs the study used a set of eight items. Table 4.8 below gives the summary of the findings based on a five point Likert scale.
Table 4.8 Debt Capital

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Range</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs relies on loan to run</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>3.31</td>
<td>.247</td>
<td>1.600</td>
</tr>
<tr>
<td>borrowing short term reduces risk of running</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>3.64</td>
<td>.233</td>
<td>1.511</td>
</tr>
<tr>
<td>borrowing long term reduces risk of investment</td>
<td>42</td>
<td>3</td>
<td>1</td>
<td>4</td>
<td>2.93</td>
<td>.134</td>
<td>.867</td>
</tr>
<tr>
<td>debt preferred due to lower information disclosure</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.93</td>
<td>.232</td>
<td>1.504</td>
</tr>
<tr>
<td>SME matches maturity of its debt</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.43</td>
<td>.210</td>
<td>1.364</td>
</tr>
<tr>
<td>issues long-term debt to min finance in bad times</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.55</td>
<td>.260</td>
<td>1.685</td>
</tr>
<tr>
<td>considers credit rating before it borrows</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>3.29</td>
<td>.249</td>
<td>1.612</td>
</tr>
<tr>
<td>firm limits its debt</td>
<td>42</td>
<td>4</td>
<td>1</td>
<td>5</td>
<td>2.74</td>
<td>.221</td>
<td>1.432</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>42</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research data, 2017

Table 4.8 above shows that the highest score for debt capital is 3.64 while the lowest score is 2.43. This shows a high deviation from the mean. This signifies different views towards debt capital. The study shows that, SMEs concentrated their responses to the middle which is neutral. This indicates that most of the SMEs don’t appreciate the use of debt capital either due to lack collateral that can qualify them access debt capital or fear the risks that accompany debt financing. Many agreed the aspect that short-term debts reduce the risk of bankruptcy.

On the issue of matching debts with the life of its assets the SMEs disagreed, this was either due to lack of experience with debts capital as generally SMEs have accumulated wealth that really attract lenders. These being SMEs their knowledge and accessibility of debt capital requires an enhancement. The findings found that the respondents are neutral and this affects the growth and success of their business to a great extent that there was a significant effect of debt capital on financial performance of SMEs.
4.5.3 Retained Earnings

Retained Earnings is the money set aside from profit of the firm and is to be reinvested in its core business, pay debts or acquired fixed assets. Retained earnings are one of the factors determining the health of small business. It is cost free and therefore proves to be the best source of internal finance. The researcher wanted to study on how the SMEs manage the retained earnings in their businesses. Table 4.9 below shows the results.

Table 4.9 Retained Earnings

<table>
<thead>
<tr>
<th>Source: Research data, 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 4.9 above shows a normal distribution of the means. The highest being 3.4 and lowest 2.6. This tells the researcher that there are challenges on management of retained earnings by SMEs. Before the respondents responded to the Likert scale</td>
</tr>
</tbody>
</table>
items, the researcher framed some questions with an intention to find out whether the respondent understands what is retained earnings, its use and factors that affects retained earnings. From the study the researcher established that, the SMEs understands and knows the factors and uses of retained earnings. This therefore enhanced the researcher’s findings and interpretations of the Likert scale results. Study findings reveal that retained earnings is the best source of finance which is ranked first fallowed by equity capital. It is the cheapest source with very minimal risks, however the problem is how to raise it.

With all the knowledge that, retained earnings is money set aside from profit, this becomes difficult since every time profit is realized, the chances of retained part of it proves difficult due to continuous and never finished financial obligations. The items on retained earnings is profit and should be used for owner consumption scored highest (agreed), this is evident that raising retained profit for use is a challenge. Being a risk free source of finance there should be more emphasis on training SMEs on the developing and management of retained earnings as this affects their financial performance

4.5.4 Initial Business Capital
The researcher aimed at identifying the initial capital of the firm in which the respondents begun with. The results were as follows.

Table 4.10 Initial capital

<table>
<thead>
<tr>
<th>Source: Research data, 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequency</td>
</tr>
<tr>
<td>-----------------------------</td>
</tr>
<tr>
<td>20000-50000</td>
</tr>
<tr>
<td>50000-100000</td>
</tr>
<tr>
<td>100000-150000</td>
</tr>
<tr>
<td>Above 150000</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
Table 4.10 shows 42.9% of the respondents begun the firm with Ksh 50,000 to Ksh100,000. The second large group at 40.5% begun with Ksh100,000 to Ksh150,000. Therefore a capital of between Kshs 50,000 to Kshs 150,000 was used as initial capital. A capital of this range would enable one start small business and due to the fact that a good number seeks financial management skills (Referring table 4.4) they have been able to remain in business and have experienced some growth.

4.6 Preliminary Diagnostic Tests.

The researcher sought to carry out a diagnostic test on the variables to identify areas of weakness and strength in order to determine the usefulness of the study towards its intended purpose. Test carried were on multicollinearity, heteroscedastic and normality

4.6.1 Multicollinearity test

Multicollinearity determines whether there is similarity between the independent variables in a model. Similarities between the independent variables will result to a very strong correlation. VIF (Variance inflation factor) of multicollinearity test is used in decision making. If VIF lies between 1-10, then there is no excessive multicollinearity. If VIF is <1 or >10, then there is excessive multicollinearity.

4.6.1.1 Equity Capital

The researcher decided to perform multicollinearity test using equity capital as the independent variable and obtained the results below

<table>
<thead>
<tr>
<th>Model</th>
<th>Collinearity Statistics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tolerance</td>
<td>VIF</td>
</tr>
<tr>
<td>Debt capital</td>
<td>.999</td>
<td>1.001</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>.999</td>
<td>1.001</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

The Dependent variable in this test is whether the financial performance of the firm is sound. Considering the high tolerance values and low VIF values, this is an indication of no excessive multicollinearity.

### 4.6.1.2 Retained earnings

The researcher decided to perform the multicollinearity test using the retained earnings variable as the independent variable and obtained the following results.

**Table 4.12 Coefficients Table**

<table>
<thead>
<tr>
<th>Model</th>
<th>Collinearity Statistics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tolerance</td>
<td>VIF</td>
</tr>
<tr>
<td>1</td>
<td>Equity capital</td>
<td>1.000</td>
</tr>
<tr>
<td>1</td>
<td>Debt capital</td>
<td>1.000</td>
</tr>
</tbody>
</table>

Dependent Variable: Financial Performance.

**Source:** Research data, 2017

Considering the high tolerance values and low VIF values, this an indication of no excessive multicollinearity.

### 4.6.1.3 Debt Capital

The researcher further used the debt capital variable as the Dependent variable to test for the multicollinearity and obtained the following results.

**Table 4.13 Debt Capital Coefficients**

<table>
<thead>
<tr>
<th>Model</th>
<th>Collinearity Statistics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tolerance</td>
<td>VIF</td>
</tr>
<tr>
<td>1</td>
<td>Retained earnings</td>
<td>.968</td>
</tr>
<tr>
<td>1</td>
<td>Equity capital</td>
<td>.968</td>
</tr>
</tbody>
</table>


**Source:** Research data, 2017
Considering the high tolerance values and low VIF values, this is an indication of no excessive multicollinearity the independent variables are not interrelated.

4.6.2 Heteroscedastic Test
The researcher used three variables to test for Heteroscedastic in the regression. Whether the size of the error term differs across the values of independent variables.

![Normal P-P Plot of Regression Standardized Residual](image)

**Dependent Variable: do you know retained earnings**

**Figure 4.6.2.1 Homoscedasticity**

**Source: Research data, 2017**

The results obtained shows there is homoscedasticity, the error term is the same across all values of the independent variables (the graph shows a pattern of distribution).

4.6.3 Normality test
The researcher carried out normality test to establish whether the data set was modelled for was normally distribution. He choose an item on whether equity capital alone is enough to finance a business as initial capital. SPSS version 20 was used in carrying out the analysis and produced the following results.
<table>
<thead>
<tr>
<th>Equity capital is alone enough to finance a business</th>
<th>Statistic</th>
<th>Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>2.46</td>
<td>.144</td>
</tr>
<tr>
<td>95% Confidence Interval for Mean</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Bound</td>
<td>2.15</td>
<td></td>
</tr>
<tr>
<td>Upper Bound</td>
<td>2.78</td>
<td></td>
</tr>
<tr>
<td>5% Trimmed Mean</td>
<td>2.46</td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>2.00</td>
<td></td>
</tr>
<tr>
<td>Variance</td>
<td>.269</td>
<td></td>
</tr>
<tr>
<td>Strongly Disagree</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>.519</td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Maximum</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Range</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Interquartile Range</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Skewness</td>
<td>.175</td>
<td>.616</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>-2.364</td>
<td>1.191</td>
</tr>
<tr>
<td>Mean</td>
<td>2.80</td>
<td>.200</td>
</tr>
<tr>
<td>95% Confidence Interval for Mean</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Bound</td>
<td>2.24</td>
<td></td>
</tr>
<tr>
<td>Upper Bound</td>
<td>3.36</td>
<td></td>
</tr>
<tr>
<td>5% Trimmed Mean</td>
<td>2.83</td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>3.00</td>
<td></td>
</tr>
<tr>
<td>Variance</td>
<td>.200</td>
<td></td>
</tr>
<tr>
<td>Initial firm capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disagree</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>.447</td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Maximum</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Range</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Interquartile Range</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Skewness</td>
<td>-2.236</td>
<td>.913</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>5.000</td>
<td>2.000</td>
</tr>
<tr>
<td>Mean</td>
<td>3.17</td>
<td>.401</td>
</tr>
<tr>
<td>95% Confidence Interval for Mean</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower Bound</td>
<td>2.13</td>
<td></td>
</tr>
<tr>
<td>Upper Bound</td>
<td>4.20</td>
<td></td>
</tr>
<tr>
<td>5% Trimmed Mean</td>
<td>3.19</td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>3.50</td>
<td></td>
</tr>
<tr>
<td>Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variance</td>
<td>.967</td>
<td></td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>.983</td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Maximum</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Range</td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>
The above table 4.14 presented the results of normality test from SPSS version 20 which are yet to go another step. The two numerical shapes of skewness and excess kurtosis were used. To test the normality, a further step dividing the statistic and the standard error values of the skewness’ and kurtosis in each liker scale was done as follows.

Source: Research data, 2017

<table>
<thead>
<tr>
<th>Agree</th>
<th>Std. Deviation</th>
<th>Interquartile Range</th>
<th>Skewness</th>
<th>Kurtosis</th>
<th>Mean</th>
<th>95% Confidence Interval for Mean</th>
<th>Lower Bound</th>
<th>Upper Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>-.456</td>
<td>.845</td>
<td>2.67</td>
<td>2.12</td>
<td></td>
<td>3.21</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-2.390</td>
<td>1.741</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>5% Trimmed Mean</td>
<td>2.69</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Median</td>
<td>3.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Range</td>
<td>.267</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>Std. Deviation</td>
<td>Interquartile Range</td>
<td>-.968</td>
<td>.845</td>
<td>2.08</td>
<td>1.51</td>
<td></td>
<td>2.66</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-1.875</td>
<td>1.741</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>5% Trimmed Mean</td>
<td>2.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Median</td>
<td>2.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Variance</td>
<td>.811</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Range</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strongly Agree</td>
<td>Std. Deviation</td>
<td>Interquartile Range</td>
<td>.712</td>
<td>.637</td>
<td>.533</td>
<td>2</td>
<td></td>
<td>1.232</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>.533</td>
<td>1.232</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 4.15 Normality Results

<table>
<thead>
<tr>
<th></th>
<th>Strongly Disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kurtosis</td>
<td>-2.364/1.191=-2.5</td>
<td>-2.39/1.741=-1.373</td>
<td>-2.39/1.1741=-1.08</td>
<td>-1.875/1.741=-1.08</td>
<td>-1.875/1.741=-1.08</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

For normally distributed data the Z values should be -1.96 to +1.96.
The neutral, Agree and strongly Agree results were within the range. This means the data was normally distributed.

4.7 Regression Analysis

Regression analysis is a statistical approach that is used to predict a change in a dependent variable (Y) on the basis in other independent variables (X). In the study the researcher used multiple regressions where dependent variable (Y) was financial performance and independent variables were Equity capital (X₁), Debt capital (X₂) and Retained earnings (X₃). The statistical package for social sciences (SPSS version 20) was used to compute measurements of multiple regressions.

4.7.1 Model Summary

The table 4.16 below gives various results of correlation coefficients after considering a set of data.

Table 4.16 Model summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adjusted R²</th>
<th>Standard error of the estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.683</td>
<td>0.466</td>
<td>0.423</td>
<td>0.203</td>
</tr>
</tbody>
</table>

Source: Research data, 2017

The above table 4.16 gives a summary of regression analysis model. The table displays the results of multiple regression where the dependent variable was financial performance and independent variable were equity capital, debt capital and retained earnings. The degree of association between financial performance and equity, debt and retained earnings is shown by correlation coefficients (R). The findings shown that there was a strong positive correlation between financial performance and Equity Capital, Debt capital and Retained Earnings collectively of 0.683.
Coefficient of Determination (R²) in the study shows how the variability in dependent variable (Y) is caused by changes in independent variables (X₁, X₂, X₃). The results of adjusted R square indicates that 42.3% of changes in financial performance is explained by the capital structure components collectively (equity, debt and retained earnings) while the other is beyond the scope of the study.

4.7.2 Analysis of Variance

Table 4.17 below tests the goodness of fit of the model by interpreting the p-value as well as the beta coefficients.

Table 4.17 Analysis of Variance

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>1.265</td>
<td>3</td>
<td>.422</td>
<td>10.538</td>
<td>.000b</td>
</tr>
<tr>
<td>Residual</td>
<td>1.521</td>
<td>38</td>
<td>.040</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.786</td>
<td>41</td>
<td>.04</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Significance level of 0.05

Source: Research data, 2017


b. Predictors: (Constant): Equity Capital, Debt Capital, Retained Earnings

The P-value (0.000) is less than 0.05 significance level an indication that the model was statistically significance hence, the model is a good fit.

4.7.3 Coefficients Table

This was used in interpreting the beta and the p-value of the independent variables (Equity capital, Debt capital and Retained earnings) and also display regression analysis results.
Table 4.18 Regression Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
<th>interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>2.473</td>
<td>.327</td>
<td>7.571</td>
<td>.000</td>
<td>significant</td>
</tr>
<tr>
<td>Equity Capital</td>
<td>-.248</td>
<td>.103</td>
<td>-.513</td>
<td>-2.414</td>
<td>Significant</td>
</tr>
<tr>
<td>Debt capital</td>
<td>.273</td>
<td>.113</td>
<td>.506</td>
<td>2.422</td>
<td>significant</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>-.022</td>
<td>.084</td>
<td>-.041</td>
<td>-.259</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

Level of significance = 0.05

Source: Research data 2017

The results from table 4.18 were used to formulate the regression model of the study as discussed in chapter three. The focus is mainly on the unstandardized coefficients, as the section includes a Y-intercept term (beta zero) as well as a slope term (beta one). For the Y-intercept to equal to zero, standardized coefficients were based on re-scaling of the variables.

Regression Function

\[ Y = 2.473 - 0.248X_1 + 0.273X_2 - 0.022X_3 \]

The beta coefficients explain a one unit contribution of each predictor variable in explaining the dependent variable. The regression equation has been developed from the unstandardized coefficients which includes the y-intercepts term (beta zero) as well as a slope term (beta one). Unstandardized coefficient beta of 2.473 shows that the financial position will be at that level when all other factor (Equity capital, Debt capital and Retained earnings) are held constant. The study shows that, putting all other Independent factors at zero, a unit increase in equity capital will lead to a 0.248 decrease in financial performance all else constant; a unit increase in debt capital will lead to an 0.273 increase in financial performance all else constant while a unit increase in retained earnings will lead to a 0.022 decrease in financial performance all else constant.
The statistical significance of individual capital structure components on financial performance can be explained by the p-values. Out of the three independent variables, two have a p-value that is less than 0.05. Equity capital has 0.021, hence the study rejects the null hypothesis that equity capital does not have a significant effect on financial performance. A p-value, (0.020). The study finds that debt capital has a significant effect on financial performance. Hence, a null hypothesis that debt capital does not have a significant effect on financial performance is hereby rejected. The p-value of SME relying on retained earnings to run the business was 0.797, this is greater than 0.05. Hence, the null hypothesis that a retained earnings does not have a significant effect on financial performance is hereby accepted.

4.8 Discussions and Key Findings

The causal research design was applied as it involved collection, verification and synthesis of evidence that establishes facts that defended or refuted a hypothesis. The findings indicated a strong positive relationship of 0.683 between variables. Also revealed 45.4% capital structure of SMEs can be explained by independent variables. The researcher used stratified sampling technique to reach at 28 SMEs. The study found that a retained earnings was the cheapest source of finance. The study recommended that an entrepreneur should go for a capital mix that will give an optimum capital structure. No business small or large can operate with only one type of capital. Also more training to SMEs is needed to ensure proper utilization of available finance.

The study findings indicated a strong positive correlation (R=0.683) which is above the average 0.5. There was also a variation of 46.6% on financial performance of SMEs in Embu County due to changes in equity capital, debt capital and retained earnings. The findings of the study indicated that, most of the SMEs (42.86%) stated their business with a capital of around Kshs. 50,000 to Kshs 100,000. About 59.52% go for financial advice; this has made SMEs in Embu County experience tremendous growth in recent years. The general statistics showed there was skewed distribution of the data used. On the preferred capital, equity capital proofed to be preferred by many respondents (about 61.9%) as compared to debt capital, however many SMEs cannot afford enough equity capital and relies on debt capital. Githaiga (2015) states that, the abundance of loan
facilities plus the demanding approval requirements of the scantly available equity fund have led many of the SMEs to resort to debt.

On the source of equity capital, majority got their equity capital from employment. Retained Earnings has proved to be the best source of capital. Myers and Majluf's (1984) argue that adverse selection implies that retained earnings are better than debt and debt is better than equity. The similarity independent variables were tested negative since all the three VIF were between 1 and 10. The pattern in the distribution graph indicated the error term was the same across all values of the independent variable. The sets of data were normally distributed and had a relationship. The analysis of variance had p-value of less than 0.05 indicating a model that was of good fit.
CHAPTER FIVE
SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The chapter targets to capture the results from the study which signifies how the capital structure affects the financial performance of SME’s. It will present a summary of the findings, give conclusions and suggest recommendations according to the research objectives. To be able to raise an optimum capital structure that comprises equity capital, debt capital and retained earnings the study will give recommendations on how to choose the best source and the ratio that gives the optimum capital structure. It will also give limitations encountered during the study and suggestions for further research.

5.2 Summary

The goal of the study was to find the effects of capital on financial performance of SMEs in Embu County. To enhance the achievement of objectives the researcher sampled registered SMEs in Embu County as at 31st December 2016. Primary data was used in this study. Was collected by use of questionnaires that contained open and closed ended questions. The respondents were required to fill both qualitative and quantitative data. For data analysis, the researcher applied Statistical package for Social Sciences (SPSS version 20) data analysis software to analyze quantitative data together with descriptive and thereafter presented it in tables and figures.

The study sought to investigate the effects of capital structure on financial performance of small and medium enterprises in Embu County. The independent variables were Equity capital, Debt capital and Retained earnings while financial performance was the dependent variable. The study tested three null hypotheses that included; Equity capital does not have significant effect, Debt capital does not have significant effect and Retained earnings does not have significant effect on financial performance of SMEs in Embu County, Kenya. According to the study findings, equity capital and debt capital have significant effect while retained earnings doesn’t have significant effect on financial performance of SMEs. This depends on how much each source represents in
the capital structure. Each SME will have its own composition of the capital structure that ensures minimum weighted average of cost of capital.

The study was to establish the effect of equity capital on financial performance of SMEs in Embu County. Equity capital is what the owner contributes to the business; it is permanent source of finance. Quite a number of SMEs appreciated the fact that equity capital is the best source of finance especially when one is starting the business. This is due to its low risk unlike debt capital that a business can suffer a lot in case of unforeseen eventuality that may lead closure. The study findings were clear that, no SME can raise enough equity capital hence there is need for other sources of finance. Many small businesses raises there equity capital from personal savings and family support. The findings also revealed that equity holders are entitled to divided that keeps on varying depending on the business performance. The null hypothesis is therefore not true since the study have shown equity capital has a significant effect on financial performance of SMEs in Embu County.

The study findings reveal was a significant effect on financial performance from debt capital. The researcher found that SMEs are aware of what is debt finance, is the money borrowed and repayable with an interest. Majority prefers a short-term loan which according to them has low risk and also lack collateral. There is need to have a good relationship with financial institutions (banks) which must be maintained by adhering to the terms and conditions. The study found that equity capital is limited to sources but debt capital will depend an assessment and judgment from the lending institution. Even though debt capital can be available anytime, the study found that one cannot borrow any amount since this can lead to liquidity problems due high gearing. This therefore supports the alternative hypothesis that debt capital has a significant effect on financial performance of SMEs in Embu County.

The study was to determine whether retained earnings have significant effect on financial performance of SMEs. For better results the researcher sought to find out whether the SMEs has information about its uses and factors that may affect retained earnings of a firm. According to the findings retained earnings is the money set aside from the profit. It may be affected by factors like dividends paid, net profit for the year, age of the organization and future plans of the firm. The researcher found that SMEs recommended some uses of retained earnings that includes paying debts, purchasing
fixed assets, expanding the business and supporting core business activities like research. On the side of raising finance retained earnings proved to be the cheapest source. However, many firms find difficulties in raising retained earnings due to non-controllable factors like economic, political, climatic etc that makes it hard for a firm to breakeven hence small profit margin or none at all. The study therefore accepts the null hypothesis and finds that, retained earnings does not have a significant effect on financial performance of SMEs in Embu County.

5.3 Conclusion

According to the study capital structure is an important factor on the financial performance of small and medium enterprise in Embu County. The study has indicated that a good number of respondents understands the concepts of equity capital and prefers it as a source of finance as it is not redeemable and it is permanent source of finance. The owner controls the business and enjoys profits whenever it’s high and bears the risk alone. It does not entail any charge. This therefore shows equity capital forms higher proportion of capital structure hence has a significant effect on financial performance of SMEs.

Debt capital has a negative effect on the performance of SMEs due to its fixed interest that must be paid where the firm makes profit or not. The study concludes that, firms with good asset base attracts lending financial institutions hence boosting their performance as they are able to face challenges that are in business cycles. However, the study refutes high rate of borrowing as this can have negative effect to the financial performance of a firm especially when gearing ratio exceeds limit. It’s quite important for every firm irrespective of the size acquire fixed assets so as to boost their financial position and build the borrowing capacity. The study therefore shows that, debt capital has a significant effect on financial performance.

From the study retaining earnings was well appreciated irrespective of not having a significant effect on financial performance due to challenges of raising it. It stands a chance of being the best source of finance for expansion because it is the cheapest and painless method of raising additional capital. It is money set aside from profit, therefore for any business to raise retained earnings it must make profit and have a good retention policy. Many businesses have therefore preferred equity and debt capital in
financing their operations. It can be used to expand the business, acquire fixed assets, and repay loans and implementation of future plans all geared towards improving financial performance of the firm. The researcher concludes that retained earnings have insignificant effect on financial performance of SMEs.

5.4 Recommendations

Having established the effect of capital structure on financial performance of SMEs in Embu County, the researcher would wish to give recommendations to various stakeholders which includes management, lending institutions, government and researchers. Management of SMEs should ensure that the capital structure of the firm is always at optimum. The firm cannot only survive on equity capital due to its low risk, also cannot wholly depend on debts due to high risk, more so retained earnings is only realized after making profit. They should develop an investment policy that will enable them maintain an optimum capital structure. I further recommend them to seek financial advisory services and carry out a continuous survey of their firm’s liquidity position and an audit to their books of account.

On lending institutions, they will understand why despite the high number of SMEs in Embu County not all are able to qualify for debt capital. They are limited by lack of collateral. The lending institution should develop structured ways of financing SMEs so as to boost their financial performance which may improve their lending business. Lending institution need to develop products like asset financing that are tailor made to the SMEs. Also they should organize informative forums and seminars that will enhance their interactions with SMEs. Most of the SMEs have psychological fear against the financial institutions like banks and beliefs that, those are for big businesses. So its high time the lending institutions make effort to breach the gap between them and SMEs.

The Government benefits indirectly from the operations of SMEs, have great impact towards the economy, when they thrive it’s to the benefit of the government. They pay tax and provides employment to many people, these are some the factors that facilitate economic growth. The government should create a conducive environment for the SMEs. The government through its organs like chamber of commerce should formulate policies that will see SMEs do their business and grow to large business. SMEs need
things like proper security, good infrastructure and business friendly policies that can enhance the growth of their business.

The study focused on capital structure and its effects on financial performance. To the researchers I would recommend them to research on how cost of capital affects capital structure of the firm the firm. They will establish on how one would arrive at optimum capital employed after mixing all the available sources of capital. This might help one understand the relationship between cost capital and financial performance of a firm. Also they can use the study findings in supporting their findings and citing so as to enhance their study findings. This can be of great importance since the study is among the latest and has captured most of current research findings on capital structure and financial performance

5.5 Limitations of the Study

The study encountered a few limitations which were worth noting. On financial performance the figures required were only on annual basis. Analysis was therefore done on annual figures creating assumptions that they were evenly distributed throughout the year. Some SMEs could hide some data for fear of information reaching the competitor and therefore gave estimates which may have affected study findings. The aim was to have two respondents per SME business to fill the questionnaire with a position of a manager and a proprietor which was a challenge as these are small businesses, however the researcher found a good number of SMEs that met the expectation. In addition there was a challenge of tracing the proprietors due to their busy schedule and not always at the premises. Due to respondents busy schedule the time given for them to fill the questionnaires was not enough, this made the researcher adjust his program to allow for an extension of one week. Others were not willing to give the information due to its sensitivity. Accessibility of SMEs was a challenge considering their fairly remote locations and the size of Embu County. Time was also a constraining factor considering that the researcher was not working in Embu County.

5.6 Contribution to knowledge

The study findings indicated that equity capital, debt capital and retained earnings have significant effects on financial performance of SMEs. The findings will help SMEs and other businesses on determining the optimum capital structure of their firms. The study
findings will also enhance the knowhow of the business communities on how they can improve their financial performance. The study findings can work for both small and large business since an optimal capital structure is a major factor towards a healthy financial performance. These findings can also be of great relevance to financial institution, they need to know that even SMEs can contribute towards their financial objective (profit maximization). The governments need to put more focus to the SMEs, this is supported by the fact that SMEs contributes significantly to the economy by paying taxes and creating jobs. The researchers need also to utilize the study in comparing the results of their study on capital structure and financial performance as well as support their findings on founded similarity as they carry out their own.

5.7 Areas for Further Research

The study having established that capital structure has a significant effect on financial performance, the researcher recommends a further study on establishing a ratio that can be recommended on components of capital structure. Study findings revealed equity capital as the most preferred source of capital, the researcher recommends a further research on debt capital and retained that could improve their preference to the same level as that of equity capital. The study only considered SMEs in Embu County the findings indicated a great effect of capital structure on financial performance. The researcher therefore recommends a similar study in other counties to be done in order to generalize the findings. Contrary to the researcher’s expectation that SMEs do not have skills of managing business, quite a number have undertaken business courses in various institutions and forums. A similar study on large businesses in Kenya may also be of significance so as to have a bigger picture on capital structure and financial performance. Finally a research should be carried out where a large sample is used in this case to see if the model summary could be affected and see its reliability in prediction of performance of SMEs in Kenya.
REFERENCES


OECD (1976), *SMEs: Employment, Innovation and Growth- The Washington Workshop Paris*


My name is Joseph Kinyua Ruri. I am undertaking a master’s degree course in Business Administration (Finance Option) at Kenyatta University. I am currently undertaking a research study on the EFFECTS OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN EMBU COUNTY, KENYA. The purpose of this letter is to request you to provide the necessary information that is required to enable me achieve the objectives of this study. Kindly note that all your responses will be treated with utmost CONFIDENTIALITY. It is important that you give honest views. Please read the items CAREFULLY and UNDERSTAND and answer ALL the questions in both sections.

Thank you for your anticipated responses.

Yours faithfully,

JOSEPH KINYUA RURI
D53/OL/EMB/26718/2014
MOBILE: 0721-474 372
Email: jkruri@gmail.com
APPENDIX B: QUESTIONNAIRE

QUESTIONNAIRE No: .................... Date....../...../2017

(Information provided will be highly confidential)

SECTION A: GENERAL INFORMATION

1. Which year was the business established? (tick)

<table>
<thead>
<tr>
<th>Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
</tr>
<tr>
<td>Before 2012</td>
<td></td>
</tr>
</tbody>
</table>

2. Please indicate your gender

   MALE [ ]  FEMALE [ ]

3. Do you go for services of financial adviser? YES [ ] NO [ ]
   If yes, which services

4. Is the liquidity position of the business at risk? YES [ ] NO [ ]
   Please explain your answer above

5. Have you acquired any financial management skills? YES [ ] NO [ ]
   Please explain your answer above

6. The core objective of an entrepreneur is maximizing profit. Does the business achieve this objective? YES [ ] NO [ ]
   Please briefly explain your answer above
SECTION B: CAPITAL STRUCTURE

B1. EQUITY CAPITAL

1. Do you understand the term equity capital?  YES [ ]  NO [ ]
   Please briefly explain your answer above ..............................................................
   ..............................................................................................................................

2. What are your sources of equity capital? (tick)

   Personal Savings
   Farming
   Employment
   Family support

   Others (specify).................................................................

3. Is the equity capital at optimum?  YES [ ]  NO [ ]
   Please briefly explain your answer above ..............................................................
   ..............................................................................................................................

Please indicate using the scale (1-5)

5 - Strongly agree:  4 - Agree:  3 - Neutral: 2 - Disagree: 1-Strongly disagree

<table>
<thead>
<tr>
<th></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. The SME relies on equity capital in order to run</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. The SME has less burden of current liabilities as compared to current assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Equity is preferred to</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>4.</td>
<td>Reserve levels are maintained to ensure continuity of operations</td>
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<tr>
<td>5.</td>
<td>Equity capital has more advantages than all other sources of capital.</td>
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<tr>
<td>6.</td>
<td>Equity capital alone is enough to finance a business.</td>
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<tr>
<td>7.</td>
<td>Members receive flexible dividends from their savings</td>
<td></td>
<td></td>
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<tr>
<td>8.</td>
<td>With the use of equity, the firm maximizes the weighted average cost of capital</td>
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</tbody>
</table>

**B3: DEBT CAPITAL**

1. Do you know the meaning of debt capital? YES [ ] NO [ ]
   
   Please briefly explain your answer above ..................................................
   ..............................................................
   ..............................................................

2. Which debts do you prefer?  Long-term [ ]  Short-term [ ]
   
   Explain your answer above..............................................................................
Please indicate using the scale (1-5)

5 - Strongly agree:  4 - Agree: 3 - Neutral: 2 - Disagree: 1 - Strongly disagree

<table>
<thead>
<tr>
<th></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>The SME relies on loan in order to run the business</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2.</td>
<td>Borrowing short term reduces risk of investment projects</td>
<td></td>
<td></td>
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<tr>
<td>3.</td>
<td>The SMS prefers debt due to close relationship with bank(s)</td>
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<tr>
<td>4.</td>
<td>Debt preferred to equity due to lower information disclosure</td>
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<td></td>
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<tr>
<td>5.</td>
<td>The SME matches the maturity of its debt with the life of its assets</td>
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<tr>
<td>6.</td>
<td>The SME issues long-term debt to minimize the risk of having to finance in bad times</td>
<td></td>
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<tr>
<td>7.</td>
<td>The firm considers its credit rating before it borrows</td>
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<tr>
<td>8.</td>
<td>The firm limits its debt so that its customers/suppliers are not worried about its financial stability</td>
<td></td>
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</tr>
</tbody>
</table>
B3: RETAINED EARNINGS

1. Do you understand what is retained earnings?  YES [ ]  NO [ ]

Please briefly explain your answer above…………………………………………………………

2. No difference between retained earnings and reserves. Agree [ ] Disagree [ ]

Please briefly explain your answer above…………………………………………………………

3. Mention any 4 factors that affect retained earnings
   a) ………………………………..
   b) ………………………………..
   c)………………………………
   d)………………………………

2. List any 4 uses of retained earnings in the business
   a) …………………………………………………..
   b) …………………………………………………..
   c)………………………………………………...
   d)………………………………………………..

Please indicate using the scale (1-5)

5 - Strongly agree:  4 - Agree: 3 - Neutral: 2 - Disagree: 1-Strongly disagree

<table>
<thead>
<tr>
<th></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Retained earnings is profit and should be used for owner consumption</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>Retention ratio is irrelevant when declaring divided</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>
3 Retained Earnings is money kept in the bank for future use.
4 To promote growth retained earnings needs to be reinvested.
5 Reserve levels are maintained to ensure continuity of operations.
6 Retained earnings are cheapest source of finance.
7 Retained earnings lowers the gearing ratio thus reducing chances of liquidation.
8 When profits are insufficient for investment, better to delay than issue new securities.

SECTION C: FINANCIAL PERFORMANCE

1. Do you think that the financial performance of the firm is sound  YES  NO
   Please explain your answer above  

2. Are there challenges facing your financial position target  YES  NO
   Please explain your answer above  

3. How much was the initial capital of the firm? (tick)
   20,000-50,000
   50,000-100,000
   100,000-150,000
   Above 150,000
1. Kindly provide the financial data for each of the financial on yearly basis as captured in the table below.

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Current assets(kshs)</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Current liabilities (kshs)</td>
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</tr>
<tr>
<td>Net income (Assets – liabilities)</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Asset base (kshs)</td>
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<td></td>
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<td></td>
</tr>
</tbody>
</table>

THANK YOU