CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN UGANDA: A CASE STUDY OF KABALE MUNICIPALITY KABALE DISTRICT

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A DISSERTATION SUBMITTED TO THE SCHOOL OF BUSINESS IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF A MASTER OF BUSINESS ADMINISTRATION OF UGANDA CHRISTIAN UNIVERSITY

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UGANDA CHRISTIAN UNIVERSITY

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DECLARATION

I **KICONCO CHARITY**, hereby declare that this research report is my original work and has never been submitted for any other master's degree to other institutions of higher learning before.

Signature  Date:19th Sept 2023

KICONCO CHARITY

APPROVAL

This is to certify that this research dissertation entitled "Capital Structure and Financial Performance of Small and Medium Enterprises in Uganda: A Case Study of Kabale Municipality, Kabale District" and approved as a University supervisor for the partial fulfilment of the ward of Masters in Business Administration at Uganda Christian University, Kampala.

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19/SEP/2023

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Date

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LIST OF ABBREVIATIONS AND ACRONYMS

MTIC	Ministry of Trade, Industry and Cooperatives
MFIs	Micro Finance Institutions
SMEs	Small and Medium Enterprises
UBOS	Uganda Bureau of Statistics
UIA	Uganda Investment Authority

ABSTRACT

The study was carried out to establish the effect of capital structure on the financial performance of SMEs in Kabale Municipality. Specifically, the study concentrated on establishing the effect of debt capital on financial performance of SME's in Kabale Municipality, the effect of equity capital on financial performance of SME's in Kabale Municipality and determining the effect of retained earnings on financial performance of SME's in Kabale Municipality. The study involved 225 respondents from 3 sectors of food processing, real estate, and accommodation and food services and it adopted cross-sectional designs using both quantitative and qualitative Research approaches. Data analysis was done using SPSS and interpreted using mean range 5- point Likert scale and Pearson correlation analysis. This study found out that there is a positive and significant relationship between effectiveness in debt capital and financial performance of selected SMEs in Kabale Municipality. The relationship between the two variables is supported by the r. value of 0.391** and significant value of 0.000. This finding implies that any unit improvement in effective use in debt capital among the selected SMEs in Kabale Municipality can lead to improvement in the level of financial performance among SMEs in Kabale by 39.1 %. The study also found out that any variation in equity capital implementation will lead to a positive and significant variation in financial performance. This finding is confirmed by the Pearson Correlation value (r) of 0.411** and significant value of 0.000 which is far less than the standardized significant value 0.05. This finding suggests that any unit improvement in effectiveness in equity capital among the selected SMEs in Kabale Municipality can lead to improvement in the level of financial performance by 41.1 %. Lastly this study found out that effective use of retained earnings can significantly and positively impact on financial performance of the selected SMEs in Kabale Municipality. This finding is supported by the significant value of 0.000 and the Person Correlation of 0.698**. This finding means that the financial performance of the selected SMEs in Kabale Municipality will be boosted by 69.8% in every unit improvement in the effective use of retained earnings among SMEs. Based on the conclusions related to the specific objectives, it can be concluded that there is a significant relationship between capital structure and financial performance among SMEs in Kabale Municipality-Uganda.

CHAPTER ONE

INTRODUCTION

1.1 Introduction

This chapter of the study presents background of the study, statement of the problem, objectives of the study, scope of the study, justification of the study, significance of the study and conceptual framework as explained below.

1.2 Background of the Study

The small and medium enterprises (SMEs) has an outstanding performance at the global, regional and local levels, despite the rapid technological changes, globalization and the disadvantages faced regarding the large companies in almost all the world (Sorgorb-Mira, 2017). These companies are major players in most of the countries, due to their ability to generate jobs and wealth. Despite their contribution to the various economies, their failure rate globally is an area of concern for both technocrats and scholars.

For instance, in developed countries like United States of America, 20 percent of SMEs fail in their first year, 30 percent of SMEs fail in their second year and 50 percent of SMEs fail after five years in business (Gill, Biger, & Mathur, 2019). Finally, 70 percent of SME owners fail in their 10^{th} year in business (USA-Bureau of Labour Statistic Report, 2020).

Roughly 80% of UK companies fail within their first year, and according to the latest figures from the office for National statistics, only 42.4% of businesses started in 2018 were still trading five years later in 2018 (Gleason, 2019). Over 600,000 SMEs (0-249 employees) are at risk of collapsing in 2020, according to new research by small business insurance provider called simple business. In Analysis of official government figures from the past five years from 2019-2018 also reveals the average annual rate of business closures is 10.8% (Gleason , 2019). There were an estimated 5.82 million SMEs (0-249 employees) in the UK in 2019, turning over £2.2 trillion and

accounting for 99% of the total business population, so the collapse of small businesses could be a huge blow to the UK economy (Titman and Wessels, 2016).

In South Africa, it is estimated that the failure rate of SMEs is between 70% and 80% (Adeniran and Johnston, 2018). Around 440,000 small businesses have closed in the last five years in South Africa. In addition, the number of new businesses start −ups are at an all-time low. The country′s high failure rate of new SME creation rate paints a bleak picture of SME sector′s potential to contribute meaningfully to job creation, economic growth and poverty reduction (Magoro, K., & Abeywardhana, D.2017).

In Kenya, 70% of Small and Medium Enterprises fail within their first three years of existence (Jacqueline et al, 2017). SMEs in the country employ ten to 250 employees and serve the economy by satisfying the demands of various economic entities for which there are no or lower scale economies of production or distribution (Muiru, &Kamau, 2018). Similarly, in Rwanda, the official figures show that from 2018 to 2018, around 15 per cent of small businesses collapsed (Hakuziyaremye, 2019).

Among the factors that have been noted to influence performance of SMEs is capital structure. As observed by Kyule, & Ngugi, (2015) evaluated the relationship between the capital structure and the performance of SMEs in South Africa and Ghana, found a significantly negative relationship of the financial leverage measured by the ratio of short-term debt, and positively significant with the long-term debt. Similarly, other scholars like; Berger, & Udell, (2018); Kuria, (2016); Bryman, (2017); and Nassar (2016) revealed that capital structure influence performance of SMEs.

1.2.1 Historical background

The history of capital structure in business financing began thousands of years ago with farmers using seeds and grains to borrow capital and livestock as repayment options. The very earliest example of lending dates to over 4,000 years ago in Mesopotamia, 2,000 BCE, where the very first payday loans were used by farmers. Whether or not capital Structure applied in a small tribe or unknown civilization before this is a mystery, but 2,000 BCE is the very first evidence that we have recorded. In 1950, Frank McNamara made history when he paid a restaurant bill with a cardboard card. A few years later the Bank of America started launching the BankAmerica, the

good old fashion Visa. By 1959 FICO scores were wide-spread and used by business owners to evaluate the different means of funding (Bradley, Javrell, & Kim, 2019).

The history of private equity in business financing is traced back to 1901, when J.P. Morgan--the man, not the institution--purchased Carnegie Steel Co. from Andrew Carnegie and Henry Phipps for $480 million. Phipps took his share and created, in essence, a private equity fund called the Bessemer Trust. Today the Bessemer Trust is more private bank than private equity firm, but Phipps and his children started a trend of buying exclusive rights to up-and-coming companies--or buying them outright (Bryman, 2017).

According to historians and economists of leasing transactions were, in ancient Sumer and the state date back to around 2000 BC. er. In the early 60's American business "moved" leasing across the ocean to Europe, where the first leasing company - "Deutsche lising GMBH" appeared in 1962 in Dusseldorf. By the mid-60's leasing operations in the U.S. accounted for 1 billion dollars. By the end of the 80 years they have exceeded 110 billion dol.2, ie a quarter-century have increased by more than a hundred times (Baker, and Zingales, 2018).

Factoring's origins lie in the financing of trade, particularly international trade. It is said, Bradley, Javrell, & Kim, 2019 that factoring originated with ancient Mesopotamian culture, with rules of factoring preserved in the Code of Hammurabi. Factoring as a fact of business life was underway in England prior to 1400, and it came to America with the Pilgrims, around 1620 (Anderson, & Gerbing, 2016). It appears to be closely related to early merchant banking activities. The latter however evolved by extension to non-trade related financing such as sovereign debt (Tomaso, and Dubbini, 2015). Like all financial instruments, factoring evolved over centuries. This was driven by changes in the organization of companies; technology, particularly air travel and non-face-to-face communications technologies starting with the telegraph, followed by the telephone and then computers. By the first decade of the 21st century, a basic public policy rationale for factoring remains that the product is well-suited to the demands of innovative, rapidly growing firms critical to economic growth (Hadlock and James, 2016).

1.2.2 Theoretical background

Hierarchy theory

The theory to be used in this study is the Hierarchy theory. The hierarchy theory states that domestic sources of funding are a priority, while the use of external sources will be postponed

until internal sources are exhausted. Therefore, the order of preference of the financing sources in a company are internal equity, then the debt issuance, and finally, the shares issuance (Chittenden, F et al, 2019) and to the extent they design better their capital structure, better business results will be obtained.

The hierarchy theory was used in this study as an aid that allows to investigate the effect of capital structure on the financial performance of SMEs. The Central idea in the hierarchy theory is that older businesses should be less dependent on external financing sources than younger businesses. It also attributes to the fact that older businesses have more opportunities to earn profits than younger businesses and that such profits can be used to finance the operations.

1.2.3 Conceptual background

Capital structure: Capital structure refers to the mix of its financial liabilities. As financial capital is an uncertain but critical resource for all firms, suppliers of finance are able to exert control over firms (Kyule &Ngugi, 2015). Business′s capital structure is then a composition or a structure of its liabilities (Berger, & Udell, 2018). In this study, the indicators of capital structure are the; Owner′s Equity, Debt Capital and Retained Earnings.

Small and Medium-scale Enterprises and large firms alike are often faced with a decision dilemma on the amount of debt and equity, they should adopt in financing their operations. Extant literature indicates that small firms prefer to use their own funds rather than borrowing due to the associated risks (Mac an Bhaird & Brian, 2011). The scholar maintains that the inadequacy of the internally generated funds to finance business expansion necessitates that they borrow especially on a short-term basis due to accessibility impediments as well as the high cost associated with long-term debt. Accordingly, the firm has to determine an optimal capital structure that will maximize its value (Brigham, & Ehrhardt, 2013).

Short-term debt describes the amount of borrowing that matures in one financial period and represents the portion of assets financed by short-term borrowings (Abeywardhana, 2017). Empirical literature indicates that the most common capital structure choices of SMEs are short-

term debt, long-term debt, equity capital/ owner(s)′ funds, and retained earnings (Fama & French, 2012; Rossi, 2014; Vatavu, 2015; Forte, Barros & Nakamura, 2013; Bolek, 2014; Admassu, 2016). Short-term debt financing is a significant part of the capital structure and financing decisions of enterprises. This is because short-term loans help enterprises to meet the immediate need for financing without long-term commitment; the cost of servicing short-term debt is less taxing on the firm; and usually offer lower interest charges (Shikumo et al., 2020). However, Forte, Barros, and Nakamura (2013) argue that short-term borrowing in SMEs is not necessarily directly linked to short-term investments, neither is long-term debt for long-term investments. Additionally, Plesko (2000), maintains that including short-term borrowing in any measure of debt provides a complete picture of the cash flow needs for debt service payments. Whereas interest expense on long-term debt is incurred when interest is accrued, no current expenditure of cash is made if the interest is to be paid later. On the other hand, short-term debt, in addition to the current portion of long-term debt, provides a better assessment of the firm′s cash demands as this debt will necessitate repayment by cash or any other near-cash assets in the foreseeable future.

In agreement with the foregoing, Fosberg (2012) asserts that short-term debt could be used as a permanent source of finance if the debt is continually refinanced as it matures to take advantage of an upward sloping yield curve which reduces the firm′s interest expense. The author argues that since the yield curve is upward sloping, the interest rate on short-term debt becomes less than the interest rate on long-term debt. Accordingly, using short-term debt as a long-term source of debt finance reduces the firm′s interest expense.

Secondly, the high levels of asymmetric information challenges translating into limited access to external financing compels SMEs to depend on their internally generated resources and/ or short-term debt in financing both long- and short-term investments (Palacin-Sanchez, Ramirez-Herrera, & Pietro, 2013; Palacios, Carrillo & Guzman, 2016). The authors argue that it is less difficult for small and medium entities to finance their expansion using short-term than long-term obligations.

This further explains why short-term debt is included in most capital structure-financial performance studies such as (Abor & Biekpe, 2009; Khan, 2012; Al-Smadi, 2019).

According to Serrasqueiro (2017), resorting to short-term debt excessively in times of insufficient internal funds could deny small and medium firms the benefits of investing in profitable opportunities due to financial stress arising from managing limited financial resources. The authors argue that short-term payments of debt plus the associated interest charges limit investment in long-term potentially viable ventures in situations of insufficient internally generated resources. Accordingly, growth-seeking SMEs with limited internal funding tend to opt for long-term debt despite the accessibility challenges as well as the associated cost usually leading to poor performance (Abeywardhana, 2017).

Long-term debt represents the proportion of the firm's resources owed to third parties falling due in a period exceeding one financial year (Abeywardhana, 2017). Long-term debt is measured by the ratio of total long-term obligations and the total sum of the entity's assets. The ratio shows the percentage of assets financed by long-term borrowing. Whereas long-time debt has been used to finance current period investments among small and medium scale firms, empirical literature shows that it represents a key funding option for long-term investments notwithstanding its accessibility limitations (Nunes, and Serrasqueiro, 2017; Abeywardhana, 2017).

Debt finance remains the major source of financing for SMEs regardless of the accessibility problem. The availability of debt facilities as well as the rigorous approval requirements for equity finance from the stock exchange markets continues to make debt the most available source of financing usually from non-formal lending institutions (Wahba, 2013). Obtaining financing from informal lenders is both theoretically and practically acceptable from the formal lenders' point of view due to the perceived high risk associated with SME borrowers (Githaiga & Kabiru, 2015).

There is a wide range of long-term financing options applicable to SMEs. These include: internally generated resources such as owner-manager personal savings and retained profits, contributions from relatives or friends, and subsidies in form of grants from the government (Palacios, 2016). However, the empirical literature on the capital structure of SMEs indicates that LTD and owners' contributed resources form important sources of funds in financing long-term investments although such funds are usually used to finance short-term operations as well (Forte, Barros & Nakamura, 2013).

Equity capital relates to the resources contributed by the owner(s) and /or invested in a company without a definite repayment date where the provider of the capital is considered to be investing in the business (Abdulsaleh, & Worthington, 2013). Equity capital is measured by the ratio of total equity (owners' funds) to total assets and shows the proportion of the assets financed by the resources of the owners of the business organization (Muhammad, Shah, & Islam, 2014).

According to Palacios, 2016, equity capital can be raised from informal (internal) sources including owners' savings, contributions from friends and relatives, retained profits from business operations as well as the formal financing options including capital markets, venture financiers in addition to angel investors. In addition to providing alternative sources of finance, venture capitalists provide managerial expertise which helps resolve the information scarcity prevalent in SMEs (Abdulsaleh & Worthington, 2013). The authors maintain that by ensuring financial transparency, the SMEs' chances of accessing external formal credit are increased.

Empirical evidence has indicated that internal sources of equity capital continue to be the most reliable and preferred financing options for Small and medium-sized firms (Forte, Barros, & Nakamura, 2013). In agreement with the authors Noumigue (2015), asserts that the internal sources of equity capital are preferred because they do not affect the controlling power of the owner-managers neither do they impose financial costs to the firms. However, internally generated funds remain insufficient for business expansion in SMEs due to low levels of investment capital as well as low levels of profitability especially in economies where the external equity capital markets (venture capital and business angels) are underdeveloped (Ou & Haynes, 2016).

However, the foregoing notwithstanding, studies on the relationship between short-term debt and firm financial performance have presented contradicting results. For instance, whereas Shahjahanpour, Ghalambor, and Aflatooni (2010); Cheruyot, and Ntoiti (2015) found a negative relationship; Forte, and Tavares, (2019) document a positive relationship, while Ebaid (2009) found a weak to no impact relationship. Recent literature shows that the influence of long-term borrowing and equity on the entity's profitability has also been inconsistent. Shikumo, Oluoch,

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and Wepukhulu, (2020) established a positive effect of long-term debt on financial performance; while (Junior, de Sarvas, Rodríguez, and de Sousa Ribeiro, 2017; Rahman, Kakuli, Parvin, and Sultana, 2020) recorded a negative relationship between long-term debt and financial performance. Shubita and Alsawalhah (2012) on their part, found a positive relationship between equity and profitability as did Eton, Mwosi, Mutesigensi, and Ebong (2017).

Financial performance: Financial Performance is defined as a subjective measure of how well a business can use assets from its primary mode of business and generate revenues (Renato, 2017). It is also used as a general measure of a business's overall financial health over a given period and can be used to compare similar businesses across the same industry or to compare industries or sectors in aggression (Weinraub, 2019). In this study, the indicators of financial performance will be; liquidity, profitability, efficiency and stock levels.

Small and Medium Enterprises: Uganda Investment Authority (UIA) (2018) defines SMEs as firms or enterprises which employ 50 or more people with a revenue turnover of maximum Ugandan shillings 360 million and total assets of maximum Ugandan shillings 360 million (Turyahikayo, 2015). Ministry of Trade, Industry and Cooperatives (MTIC) (2015) also defines SMEs as enterprises employ between 50 and 100 with total assets more than 100 million but not exceeding 360 million.

1.2.4 Contextual background

In Uganda, Small and Medium Enterprises are spread across all sectors, accounting for 49% of the service sector, 33% in commerce and trade, 10% in manufacturing and 8%in other fields. Over 2.5million people are employed in this sector and account for approximately 90% of the entire private sector, generating over 80% of manufactured output that contribute 20% of the gross domestic products (Uganda Investment Authority (UIA), 2016).

In Western Uganda, Small and Medium Enterprises are also distributed across all sectors, accounting for 27% of the service sector, 45% in commerce and trade, 4% in manufacturing and

24% in other fields. Likewise, in Kabale Municipality, 8% of the Small and Medium Enterprises are in service sector, 78% in commerce and trade, 1% in manufacturing and 12% in other sectors of the economy (UIA, 2016). Some of the key challenges faced by SMEs in Uganda are lack of access to credit facilities due to lack of collateral among others (Ocici, 2016 &Goffe, 2015).

1.3 Statement of the problem

Small and Medium Enterprises (SMEs) play a crucial role in Uganda's economic growth, contributing to over 75% of the country's GDP and employing more than 50% of the workforce (UBOS, 2020). However, SMEs in Uganda face significant challenges in accessing financing, which hinders their financial performance and sustainability (Kasekende & Atingi-Ego, 2017). The capital structure of SMEs, which refers to the mix of debt and equity financing, is a critical factor influencing their financial performance Najjar, 2019). Reports show that at least 50% of small and medium enterprises fail in the first five years (Ddamulira, I. 2018). In Kabale Municipality it is reported that most of the SMEs do not perform well, and some do not last for long. At least 52% of SMEs fail in their first three years and some continue to operate in a financial deficit (Akasimire, 2019According to the report, credit growth decline reflects declining profitability in an economy where private equity is largely limited within the SME sector. The extent to which the poor performance trend is linked to the capital structure of SMEs remains analytically unclear contest.

Scholars have gone into details to explore SMEs in Western Uganda in relation to financial management however, very few of these studies have looked specifically at Capital Structure and Financial performance of SMEs in Kabale Municipality (Turyamureba, Sunday and Ssekajugo (2018); Akasimire (2019). Despite its importance, there is limited research on the relationship between capital structure and financial performance of SMEs Kabale District. It is therefore against this background, that this study will seek to establish financial influence of Capital Structure on Financial performance of SMEs in Kabale Municipality.

1.4 Objectives of the study

1.4.1 General Objective

To investigate the effect of capital structure on the financial performance of SMEs in Kabale Municipality.

1.4.2 Specific Objectives

i. To establish the effect of debt capital on financial performance of SME's in Kabale Municipality
ii. To establish the effect of equity capital on financial performance of SME's in Kabale Municipality
iii. To determine the effect of retained earnings on financial performance of SME's in Kabale Municipality

1.5. Research Questions

i. What is the effect of debt capital on financial performance of SME's in Kabale Municipality?
ii. What is the effect of equity capital on financial performance of SME's in Kabale Municipality?
iii. What is the effect of retained earnings on financial performance of SME's in Kabale Municipality?

1.6 Scope of the Study

1.6.1 Geographical Scope

The study was limited to SMEs in Kabale Municipality, Uganda. Kabale Municipality is located in the Western Region of Uganda. It is the main Municipal, administrative, and commercial centre of Kigezi Region.

1.6.2 Content Scope

In relation to the content scope, the study is to investigate the effect of capital structure on the financial performance of SMEs in Kabale Municipality. Specifically, the study concentrated on establishing the effect of debt capital on financial performance of SME's in Kabale Municipality, the effect of equity capital on financial performance of SME's in Kabale Municipality and determining the effect of retained earnings on financial performance of SME's in Kabale Municipality.

1.6.3 Time Scope

This study took a period of eight months to be completed since it will use cross-sectional research design where data will be collected at one point in time. The study will start from March 2020 up to August 2020. In addition, the study will consider information related to the period of 10 years (2011-2020). This period was considered by the study since it is long enough to help the researcher establish the relationship between the study variables of capital structure and financial performance.

1.7 Justification of the Study

The need to strengthen financial performance of SMEs in Uganda is crucial because of its perpendicular link the country's economic growth and development agenda (Ddamulira, 2018). Undertaking a study on capital structure and the performance of SMEs is argued to strengthen financial performance of SMEs in Uganda and Kabale Municipality in particular that will improve the country's economic growth and development agenda. While there is extensive research on capital structure and financial performance in developed economies, there is a scarcity of studies focusing on SMEs in Uganda (Ayyagari et al., 2017). This research aims to bridge this gap by investigating the relationship between capital structure and financial performance of SMEs in Kabale District in the western part of Uganda.

1.8 Significance of the study

The study will provide information related to capital structure and financial performance of SMEs in Kabale Municipality in particular. This means that business enterprise owners will be able to make the right decisions regarding financing their businesses that will help in improving financial performance.

The study findings will add to the body of knowledge information related to capital structure and financial performance. This means that the researcher will contribute to the literature that will be displayed in the university library for future references hence improving on the research and academic excellence of other researchers who shall focus on having better capital structure decisions followed by better Financial Performance in SMEs.

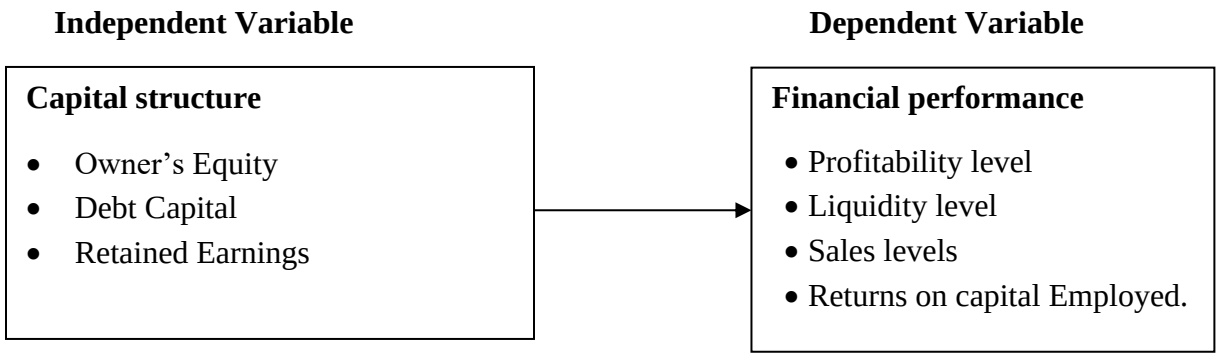
In addition, the study will investigate the effect of capital structure on financial performance. The results are likely to help policy makers in formulating policies which will be lenient to the SMEs improved Financial Performance in such businesses.

Lastly, the findings of this study will help the researcher in completing her award of master's degree in business administration of Uganda Christian University since it is a requirement for the award.

1.9 Conceptual framework

The conceptual framework illustrates the relationships between the independent variable (Capital Structure) and the dependent variable (Financial Performance) in the context of Small and Medium Enterprises (SMEs) in Uganda. In this study, two broad concepts of capital structure and financial performance were examined to determine their degree and extent of interconnectedness within the context of SMEs in Kabale Municipality. Capital structure will be considered as an independent variable and financial performance as a dependent variable (See Figure 1.1)

Figure 1.1: Showing conceptual framework



Source: Adapted from Njoroge, (2019) modified by the researcher get more scholars to back up this model.

Figure 1.1 above shows the interconnectedness between the variables, capital structure and financial performance. Capital structure of a firm is noted to constitute among others owner's equity, debt capital, and retained earnings. Njoroge 2019 argued that capital structure of a firm is

a direct bearing on a firm's financial performance as indicated by profitability, liquidity sales volume, and returns on capital employed.

The independent variable, Capital Structure consists of Owner's Equity which represents the ownership interest in the firm, including common stock, preferred stock, and retained earnings (Khan et al., 2020). Debt Capital: represents the borrowed funds used to finance the firm's operations, including short-term and long-term debt (Dang et al., 2019). Retained Earnings; represents the profits reinvested in the firm, rather than being distributed to shareholders (Ahmed et al., 2018).

The Dependent Variable, Financial Performance consists of Profitability Level which measures the firm's ability to generate earnings, including net income, return on assets (ROA), and return on equity (ROE) (Umar et al., 2020). Liquidity Level: measures the firm's ability to meet its short-term obligations, including the current ratio and quick ratio (Shah et al., 2019). Sales Levels measures the firm's revenue growth, market share, and sales performance (Javed et al., 2018). Returns on Capital Employed: measures the firm's efficiency in using its capital to generate returns, including return on capital employed (ROCE) and return on investment (ROI) (Li et al., 2020).

Capital Structure (independent variable) influences Financial Performance (dependent variable) (Goyal et al., 2020). The three components of Capital Structure (Owner's Equity, Debt Capital, and Retained Earnings) interact and impact Financial Performance (Singh et al., 2019).

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents information concerning the effect of capital structure on the financial performance of SMEs. The literature is sectionalized into theoretical review and actual literature review and ends with a summary highlighting gaps identified. The presentation and review of related literature is thematically presented based on the study objectives as follows;

2.2 Theoretical Review

Finance theory has made major developments in understanding the effect of capital structure on financial performance of SMEs. The financial theories on capital structure are irrelevance Theory, Trade-off, Pecking Order, Market Timing and Agency theories. In this study, the researcher will focus on Pecking order and Trade off theories as they are more relevant for privately held firms that do not issue publicly traded securities.

2.2.1 Pecking Order Theory

Myers and Majluf (1984) suggested 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 to 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. The issue of new common stock is one of the capital structure scenarios that can cause decline in stock price.

The rational idea behind the theory is based on the notion of asymmetric information that exists between managers and the investor (Baker and Martin, 2011). It is discussed that managers have a well understanding and further information about the firm than outsiders about the firm's future and they act in the best interest of the company accordingly (Harrison and Wisnu Widjaja, 2014; Boadi 2015). Optimal Capital Structure is not taken as a starting point in the view of pecking order theory. As an alternative the theory promotes the fact that firms prefer internal funds (retained

earnings) and use external funds only when internal sourcing is insufficient. (Myers, 1984; Myers and Majluf, 1984). Pecking order theory assumes that this is the best way for firms to act since if they issue equity to finance their operations, it indicates to the external or outsiders that the company is in lack of capital, which can result in declining stock price. It is argued that, there exists a relation between issuing new equity and reduction in stock price (Baker and Martin, 2011). Nevertheless, when external financing is necessary, the theory stresses that the choice of different finance opportunities depend on the comparative costs and the lowest risk for the investment (Myers, 1984; Boadi 2015). As a matter of fact, firms prefer issuing of debt as a first option and then equity as a last alternative (Myers, 1984; Abeywardhana, 2017).

Pecking order theory claims that, firms that are profitable and generate high earnings are also the ones that are expected to use less debt. This is because firms finance their new investments with internal funds such as retained earnings (Boadi 2015). Pecking order theory assumes that firms are more likely to be profitable and generate earnings in normal market conditions with more Retained earnings and less debt. However, during crises firms become less profitable and often face liquidity issues (Serrasqueiro & Caetano, 2015), which make firms seek debt or external funding. In other words, pecking order theory assumes a higher level of debt during financial crises where there is an increased probability that firms′ internal funds are not sufficient. Additionally, since profitable firms are in less need of debt, pecking order theory assumes a negative relationship between financial leverage and firm performance (Abeywardhana, 2017).

For the meaning of this study, Pecking Order theory is of supreme significance as is intended for the valuation of financing performance of the SMEs along the life cycle. According to the Pecking Order assumption, firms prefer to finance new investments with first internally generated funds i.e. retained earnings, then with debt and finally with as issue of new equity.

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. According to the theory, debts

and equity capital are normally the two sources of finance for a firm. (Palacios et al., 2016). In other words, the theory suggests the trade-off between debt benefits and debt costs and that every company should have an optimal capital structure (Palacios et al., 2016).

Firms benefit from leverage due to the interest deductibility of pre-tax income (Modigliani and Miller (1963). In other words, there is a tax shield to take advantage of since interest expenses reduce the taxable income and allow firms to collect tax savings (Korzh, 2015; Edet, Uma, & Udo, 2017). A positive impact of leverage on firm value is further proved by Korzh, 2015. On the other hand, Myers (Abeywardhana, 2017) claims that although firms can benefit from tax deduction by increasing their debt level, each firm should move toward their own optimal capital structure, which can mean either increasing or decreasing debt. Besides, the negative effects of leverage on firm performance are recognized by the trade-off theory. Debt financing is associated with an obligation for forthcoming cash outflow due to the interest payments on debt required in future. Hence, the financial risk in terms of bankruptcy and Insolvency increases due to interest payments that negatively affect firms′ liquidity and financial performance (Wen-Chien, 2017).

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 Myers 1984, the trade-off theory assumes that the optimal capital structure can be determined by finding the balance between the debt benefits of tax savings and the debt costs of higher risk for financial distress.

Similarly, trade-off theory assumes that during normal market conditions firms ought to increase debt if the benefits of debt go beyond the costs of bankruptcy risk. However, during crises the bankruptcy risk rises remarkably, which increases the probability that the debt costs instead exceed the debt benefits. Still, the trade-off theory provides support for the advantages of debt financing given that the firm manages the tradeoff between the debt benefits and debt costs. In other words, the tax advantages should increase the firm's performance. Even though bankruptcy costs exist, Gruber and Warner (1977) and Miller (1977) conclude that they are much smaller in relation to the tax savings. With that said, the trade-off theory argues for a positive relationship between leverage and firm performance. This positive relationship is further confirmed by many scholars such as Fosu (2013).

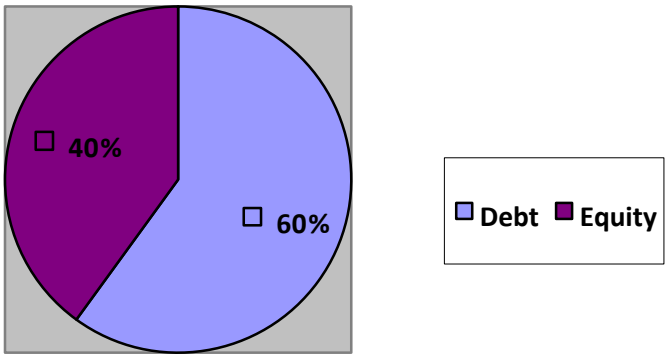
2.3 Capital structure and Financial Performance

2.3.1 Capital structure

According to Burksaitiene and Draugele, 2018, Capital structure refers to how a firm investment is financed using either equity or debt or proportionate mix of both. The research on Capital Structure is first seen by the influential study carried out by Modiglian and Miller (1958) who revealed that in the cases of perfect capital markets, Capital structure is Irrelevant. However, in the real world, through the presence of corporate taxes, interest rates and information asymmetry different levels of market imperfections prevail. Apart from M&M theory, capital structure is further classified into three theories: Trade off model (Myers,1984), the pecking order model (Myers and Majluf, 1984), and the Agency costs theory (Jensen 1986).

Capital structures describe how the firm's projects and plans are financed; however, the proportion of capital structure differs from company to company. In fact, capital structure proportion determines how the profit should be divided between creditors and the company's owners. Capital Structure is figured as a Pie, if all the Assets divided into equity and Debt (Ross, Wester field and Wahba (2013). The figure below shows the concepts in capital structure like leverage and debt ratio.

Figur 3 Capital Structure



A= D+E

A= Total asset

D= Total Debt

E= Total Equity

Roshanak Hashemi 2013

The Debt ratio shows the proportion of a firm's assets which are financed through debt and if it becomes less than one then most of the firm's assets are financed by equity. If the debt ratio becomes greater than one, then most of the firm's assets are financed by debt. "Highly leveraged" term is given to the firms with the high debt/asset ratio (Roshanak Hashemi 2013). A firm's financial leverage is calculated by dividing total debt by total equity. A high debt/equity ratio means that a firm is aggressive in financing its growth with debt. Highly levered firms are more vulnerable to downturns in their business cycles, due to their legally binding payments (Roshanak Hashemi 2013). The Company Director's one of the major concerns is usually deciding about the proportion of capital structure, since it is a trade-off between risks and costs (Ross et al. 2008). Issuing equity is expensive compared to debt which is less expensive; however, debt generates higher risk than equity. Therefore, the principal issue in capital structure composition is to find the best proportion between debt and equity (Modigliani & Miller, 1958).

The Minimization of the Cost of Capital and in return the maximization of the firm's Value is the best combination of equity and debt (Makanga 2015). This combination of debt and equity is termed as optimal capital structure. The increase in leverage generates the interest tax shield, which increases the value for the company (Modigliani and Miller (1963)). However, an increase in debt

level will increase the financial distress cost, and the result is a decrease in the company's value. According to Bradley, Jarrell and Kim (1984), the optimal capital structure is the level of leverage, which gives the best balance between the tax benefit and distress cost.

2.4 Financial Performance

Financial performance is an extent to which a company financial health over a period of time is measured. (Farah Naz 2016).

Ferah Naz 2016, also says that Financial Performance is a financial action used to generate higher sales, profitability and worth of a business entity for its shareholders through managing its current and non-current assets, financing, equity, revenues and expenses.

In Financial Accounting, SME's Financial performance is measured by applying financial ratios that show profitability levels, liquidity levels, Sales level, Return on Capital Employed and the growth rate.

Financial ratios are performance indicators that are influenced by how firms perform in terms of their efficiency and productivity, and how inputs and product prices change (Amornkitvikai & Harvie, 2016). According to Harash, Suhail, & Jabbar, 2014, SMEs performance may be measured using objective, subjective and operational measures. Financial measures (derived from the accounts of a company) are referred to as objective measures because they can be individually measured and verified. Traditional statements of finance performance, statement of assets and liabilities and management account, are not enough to effectively measure performance of businesses, which are seeking to survive and add shareholder/owner value. Measuring performance in SMEs requires identifying what the business does in terms of levels of processing and attaching key performance indicators to those processes (Madole, 2013). He observed that credit obtained from banks improves business performance in terms of increased business profit, increased employees, increased sales turnover, increased diversification, increased business capital and assets as well as reduction of poverty among customers. In addition, (Abeywardhana, 2017) noted that financial measures include profit before tax.

According to (Harash, Suhail, & Jabbar, 2014) there exists non-financial measures of performance of SMEs, and these include employee growth, customer satisfaction, satisfaction with performance of competitors and overall satisfaction. Based on the source of financing, performance of SMEs

can be measured in terms of solvability ratio, and coverage of interest (Popa & Ciobanu, 2014). Availability of finance determines the capacity of an enterprise in terms of choice of technology, access to markets, and access to essential resources, which in turn greatly influences the viability, and success of a business (Mugunchu, 2013). A new business start-up with high growth potential may use Internal funding such as grant funding pin order to develop a product before moving onto funding from business angels, venture capitalists or banks once the product is developed (BIS Department for Business Innovation and Skills, 2012). Higher finance development increases new firm entry in sectors which are heavily dependent upon external finance. Better access to finance leads to higher productivity within an economy. SMEs that do not have access to external funds due to stringent terms that the financiers tend to tie to their credit and investment have impaired capacity building (Madole, 2013). However, short-term loans are not conducive to greater productivity while long-term loans may lead to improvements in productivity (Nderitu & Githinji, 2015).

2.4.1 Financial Performance Measures

According to Ahmad 2014, most popular financial measures used by SME′s are Profitability, Liquidity, Sales Growth and Return on Capital Employed.

Profitability

Profitability is the greatest indicator of performance of SMEs who struggle for survival, on top of proving their credit worthiness and solvability to their financiers. Profitability is measured by using income and expenses. Profitability is the excess of revenue over expenses, which is seen by the ratios like gross profit margin and pre-tax margin (Odongo, 2014). Though profitability ratios are essential in measuring performance, their measurements are in most SMEs. This is because most SMEs in developing countries lack proper documentation (Turyahebwa et al, 2013). SMEs which survive on loaned capital struggle to cover their debt costs. The more firms cover debt costs using operating capital, the more they experience decreasing levels of profitability (Popa & Ciobanu, 2014). The same study observed that high debt costs reduce the profits earned by shareholders. Profitability measures help in assessing the success of a business undertaking. An undertaking that is not generating profits/revenue cannot survive (Bitila, 2014). A profitable undertaking has the capacity to pay back the owners in form of return on investment made. Solvability ratio measures

the credit worthiness of the firm and determines the constraints on cash management and hence decrease profits (Popa & Ciobanu, 2014). Solvency gauges the company's ability to pay all financial obligations if all assets are sold or continue viable operations after financial adversity.

Liquidity

According to Isaac Smith 2020, liquidity refers to **how easily an asset can be converted into cash without affecting the market price.** Cash is the most liquid asset one can have, particularly of a relatively stable currency. When assessing the health of a company, understanding the company's liquidity is important for evaluating how able a firm is to pay its short-term debts and current liabilities. Qasim & Ramiz (2011) indicate that liquidity refers to the available cash for the near future, after considering the financial obligations corresponding to that period. liquidity measured using ratios such as Acid test ratio, current ratio and working capital changes (Githaiga & Kabiru, 2014).

According to Qazim and Ramiz (2011), liquidity management is very important for every Firm that means to pay current obligations on business that include operating and financial expenses that are short term. The goal of liquidity management is to enable a firm to maximize profits of its operations while meeting both short-term debt and upcoming operational expenses, to preserve liquidity (Panigrahi 2014). To achieve this goal, the firm should eliminate the risk of inability to meet its short-term obligations on the one hand, while avoiding excessive investments in current assets on the other hand (Panigrahi 2014). Excessive investments in liquidity may lead managers to make investments towards maximizing their own utility, thus to the detriment of profitability (Fama Jensen, 2011).

2.5 The effect of Debt capital on financial performance

Debt capital refers to borrowed funds that must be repaid later. This is any form of growth capital a company raises by taking out loans. These loans may be long-term or short-term (Claire Boyte 2019). Long-term debt are long term financial liabilities, and these are loans, bonds or other securities with maturities greater than one year. They often involve long-term commitment of

interest payments. Short-term debt are short term financial liabilities such as overdrafts, loans, bonds or other securities that have a maturity date within a year. (Lisa Hassan 2015).
According to Akisimire (2016) using debt capital is advantageous to business owners because of the effect of financial leverage. This is so because, using debt capital to provide additional capital for the firm operations, equity owners get to keep any extra profits generated by the debt capital, after any interest payments. Akisimire (2016) argues that given the same amount of equity investments, equity investors have a higher return on equity because of the additional profits provided by the debt capital. As long as using debt capital does not threaten the financial soundness of a company in times of difficulties, equity owners' welcome certain debt capital uses to help enhance their investment returns.

In addition, Di Tomaso and Dubbini (2015) observe that using debt capital helps lower a business's taxes because of allowable interest deductions. Tax rules permit interest payments as expense deductions against revenues to arrive at taxable income. The lower the taxable income, the less taxes a firm pays. On the other hand, dividends paid to equity holders are not tax-deductible and must come from after-tax income. He further argues that tax savings help further reduce a firm's debt capital cost, which is an advantage that equity financing lacks.

Farna and French (2018) revealed that while using debt capital may add pressure to a firm's ongoing operations because of having to meet interest-payment obligations, it helps retain more profits within the firm compared to using equity, which requires the sharing of the firms' profits with equity holders. Using debt capital, the firm needs to pay only the amount of interest out of their profits. Using equity, on the other hand, the more profits a firm makes, the more it must share with equity investors. To take advantage of such a debt capital-financing feature, the firm will often use debt capital to finance stable business operations in which they can more easily make ongoing interest payments and, meanwhile, retain the rest of the profits (Farna and French (2018). Severin (2016) argued that after the need for regular business borrowing to pay interest on the cash flow will produce a lot of pressure, when the debt capital expires, a one-time payment of principal, which requires companies with ample cash flow and reduces the business profitability level after paying the debt capitals. Severin further argues that moral hazard of creditors is more harmful than equity holders. Moral risk manifests itself in corporate income to repay the loan in not more than

choose not to repay the loan when the cost of the behavior, which will result in great loss of creditors (Severin, 2016).

Naizuli (2018) argues that debt capital requires the firm to make regular monthly payments of principal and interest. Very young business organizations often experience shortages in cash flow that may make such regular payments difficult. He adds that most lenders provide severe penalties for late or missed payments, which may include charging late fees or penalties, taking possession of collateral, or calling the loan due early. Failure to make payments on a loan, even temporarily, can adversely affect a small business's credit rating and its ability to obtain future financing.

Another challenge associated with debt capital is that its availability is often limited space to established firms. Since lenders primarily seek security for their funds, it can be difficult for unproven businesses to obtain loans (Naizuli, 2018). Finally, the amount of money small firms may be able to obtain via debt capital is likely to be limited, so they may need to use other sources of financing as well.

Kongmanila and Kimbara (2017) holds that debt capital is a financing strategy designed to increase the rate of return on owners' investment by generating a greater return on borrowed funds than the cost of using the funds. The use of high levels of debt capital in the capital structure leads to an increase or decrease in the return on shareholders' capital (ROE) (Kongmanila 2017). Debt capital is always desirable if a firm achieves relatively high profits as it results in higher returns to shareholders (positive leverage). The use of debt capital is expected to enhance a firms' return on equity which is the ultimate measure of profitability (Ziraidah 2019). The impact of the use of debt capital on a firms' profitability can be positive or negative. Therefore, leverage would be positive if return on assets (ROA) is greater than the before tax interest rate paid on debt capital. Negative leverage occurs when a firm generates a return on assets that is less than before tax interest on debt capital (Zuraidah, 2019).

2. 6 The effect of equity capital on financial performance

Githire & Muturi, (2015) defined equity financing as a situation where business individuals invest their personal funds into their firm's businesses. Njeru (2013) also defined equity financing as the difference between assets and liabilities of the business. The main source of equity financing is from personal savings or even the sale of personal assets. Most SMEs at the start up stage tend

to use personal savings because of the moral hazard and the problem with information asymmetry. As the SME's grow and have a desire to grow further and develop, they tend to seek for alternative sources of finance (Abdulaziz & Andrew, 2013).

Equity financing can also consist of a source of own savings, contributions of the Board, the contribution of partners, property of the omission, deferred income and cash flows of the business (Kongmanila and Kimbara, 2017). Njagiet 2017 also described Angel investors as another source of equity financing. These are usually described as wealthy individuals or friends of the business owners or a group of individuals who financially support the firm because they have high believe that the business will have high growth and returns.

According to (Njagiet 2017) equity financing may include retained profits, own savings, contribution from friends, contribution from partners, deferred income and cash flow of the business. Equity financing ensures that SMEs have full control, and the equity holders must ensure that resources are allocated efficiently hence increasing financial performance (Githire & Muturi, 2015).

Gatchev, (2019) proved that equity is the predominant source of finance in situations, such as profit shortfalls, investment in intangible assets, and internally generated growth opportunities, where informational asymmetries and debt agency costs are likely to be high. Many SMEs are established as family businesses which may not pursue growth strategies (Githire& Muturi, 2015). Moreover if SMEs have unconstrained choice between external debt and internal finances they will choose not to use debt financing because of the desire to retain control and independence of the business (Njagiet 2017).

According to Kepha and Muturi (2013) most SMEs are financed by the proprietors and their relations. They usually don't prefer access to external finance since this implies reduction in freedom in managing the firm hence SMEs use equity financing to retain control and independence. SMEs that use Equity financing are seen to have a positive relation with the performance more so equity financing is said to have less risk since no fixed monthly loan repayments to make (Njagiet 2017). This optimistic performance is frequently associated with the direct control that equity holders have in their businesses and having in mind that the equity holders

have the last claim to dividends they always have to ensure that the business resources are efficiently allocated (Githire& Muturi, 2015).

Equity investors do not expect any immediate return on their money. Equity financing is not mandatory to be paid back like a loan. The businesses that use equity financing bear all the losses of the business in situation of a failure (Njagiet 2017).

Shubita and Alsawalhah (2012) suggested that firms with high profits depend heavily on equity as their main financing option. Kihinde (2012) also reveals that most of the SMEs have all equity finance structure and have less debt finance compared to equity finance. It also revealed that the earnings survival and performance of the SMEs is strongly Influenced by Equity Financing. The use of equity as a source of finance helps entrepreneurs to retain control of the business. Also, it does not have any additional financial burden and obligation to the business inform of interest. This allows the entrepreneur to use the money to finance other ventures (Kihinde (2012).

2.7 The effect of retained earnings on financial performance

Retained Earnings are accumulated profits. This is a type of equity financing that is the low cost, quick and internal method of raising funds to finance the important activities of the firm. Retained earnings represent the leftover accumulated profits of each year after paying dividends and other allocations. (Umerryk 2018). Retained earnings are always kept as reserves of the firm even when there is no corresponding investment opportunity for such funds; when the opportunity arises, the funds are employed (Baumol 2017). The volume of earnings retained in a business firm is the deciding factor for selecting the investment choices which is an indicator that the time lag usually has an impact on the return on retained earnings Audretsch and Elston 2012; Thus, firms decide the amount of earnings to be retained and then look for competent investment options.

Retained earnings also play a crucial role in evaluating the shareholders' enrichment in the long run. Through retained earnings, shareholder's device the managers' ability of utilizing the amount of retained earnings effectively to improve the market value of the firm. As cited above, the retained earnings significantly influence the market price of shares in the long run (Obuya, 2017).

Khan (2012) proved that both the dividends and retained earnings explain significant variations in share prices, given that the market assigns more weight for retained earnings in the long run.

According to Royer (2017), firms with high marginal tax rates mostly benefit from equity capitalization where retained earnings constitute a greater part of the profits. Hardiningsih and Oktaviani (2012) stated that high-growth companies would increase the use of internal funds for financing the growth. Moreover, Githaiga and Kabiru (2015) pointed out that firms with great growth potential would reduce their dependence on debt, as creditors would normally demand a higher return on their investments when firms intend to invest in risky projects.

Retained earnings are effective to the firms′ performance in that it has no cost of issue, and it is a very flexible means of finance. The firm has nothing to worry about the repayments and defaults on repayments. Retained earnings as a financing source is also effective because there is no change in the pattern of shareholding and dilution in the voting power of shareholders. More profitable firms have lower leverage ratio than less profitable firms as they can finance their investment opportunities with the retained earnings (Edim Atseye 2014)

2.8 Empirical Evidence

This section of empirical evidence deliberates on studies that have been conducted locally and globally, which studied capital structure and financial performance of SME′s. Prior studies linking Capital Structure to financial performance of SMEs have remained scanty and contradictory, more so in Uganda where only 47% of them are registered (Sekabira, 2013; Abaho, 2017; Olutayo, 2015; Obuya, 2017). The persistent performance decline, inconsistences in the empirical findings on the link between Capital Structure and financial performance of SMEs, as well as limited observed literature in the Ugandan context present a good justification to assess the effect of capital Structure on the financial performance of SMEs in Kabale District, Uganda.
Aziz and Abbas (2019) studied debt financing and company performance in Pakistan. The authors aimed at examining the relationship between different sources of finance and performance of firms in the non-financial sector. Secondary data from 14 listed firms indicated that short-term debt had a negative and significant effect on firm performance measured by return on assets. The study

focused on listed companies on the Pakistan Stock Exchange whose operation characteristics as well as economic environment differ from the Ugandan SMEs

Saeed, Gull and Rasheed (2013) examined the effect of capital structure on bank performance in Pakistan. Using data for a period of five years from the stock exchange, regression results indicated a strong and significant positive association between all the considered constructs of capital structure (short-term debt, long-term debt and total debt) and financial performance measured by return on assets. The study focused only on listed banks. This study used a representative sample of SMEs from all sectors regardless of their listing status. Lixin and Lin (2008) studied debt financing and firm value in China. Using data for a period of five years from listed firms on the Shanghai stock exchange, the correlation results indicated a negative association between short-term debt and firm performance measured by return on equity. The study used return on equity which is restricted to equity capital and therefore does not provide a comprehensive assessment of the firm's Capital Structure.

In a study with American SMEs, Titman & Wessels (2016) concluded a negative relationship between the capital structure based on external sources of funding and its performance. The authors argue that due to the costs and risks associated with external leverage, SMEs have difficulty accessing such loans as these firms are not attractive for banking institutions, therefore the interest rates they set them will be high and the loans will be mostly short-term derivative from their ability to pay may not be resolved for a long time unlike large companies (Pettit & Singer (2015). This is supported by Rajan & Zingales (2019) who found that performance was negatively correlated with the external leverage, which was confirmed by Ozkan (2019) who also explains that SMEs are more sensitive to the economic crisis and collapse in situations of financial difficulties since they have fewer resources available, so that these companies would solve to lesser extent an external leverage.

Abor (2017) evaluated the relationship between the capital structure and the performance of SMEs in South Africa and Ghana, found a significantly negative relationship of the financial leverage measured by the ratio of short-term debt, and positively significant with the long-term debt. In addition to an existing negative relationship between external financing and profitability in companies in Ghana. Seppa (2018) found that companies in Estonia follow the pecking order hypothesis to decide which is the optimal capital structure, firstly they use internal funds to finance its objectives and, finally, external sources.

(Wambugu, 2013) effects of working capital management practices on profitability of small and medium enterprises in Nairobi County, Kenya. The objective of this study was to determine the effect of working capital management practices on profitability of Small and Medium Enterprises (SMEs) in Nairobi County The study adopted a cross-sectional survey research design and, a linear regression model was used to analyze quantitative data and was developed and tested to explain the relationship between various proxies of working capital management practices and profitability of SMEs of Nairobi County. The study results of the regression analysis indicated that the dependent variables are significant and influence profitability of SMEs. The study concluded that managers of SMEs should adopt the correct working capital management practices and identify critical areas that may improve the profitability of SMEs.

In Uganda, studies that have attempted to study Capital Structure and financial performance relationship were scanty and conspicuously missing in the empirical literature, rendering research in this area in conclusive (Sekabira, 2013). Sekabira assessed the role of capital structure on profitability of SMEs focusing on Micro-Finance Institutions (MFIs) in Uganda. The study required to establish the role played by the numerous financing options on the performance of MFIs. Using panel data from 14 MFIs, regression results indicated that short-term debt had a significant negative effect on MFI performance. The study used a sample of 14 MFIs. This study used a large sample of 453 SMEs from across the sectors of the economy in Buganda region, Uganda.

2.9 Summary of Literature

The chapter has looked at the theoretical review and empirical review. The researcher in theoretical review looked at the theories which acts as the study foundation. The emphasis was paid to the pecking-order and trade-off theories by the study since they appropriately give explanation of the capital structure and firm performance.

The presented capital structure theories, pecking order and trade-off are all developed out of the fact that market imperfections exist. The basis of Modigliani and Miller (1958) with the assumptions of perfect markets and irrelevance of capital structure choice for firm value forms the base. The pecking order theory argues for this relationship between leverage and firm performance to be negative. This perspective emphasizes the internal funds as first priority for financing before raising external funds from debt and equity issuance(Myers, 1984; Myers and Majluf, 1984).In

line with pecking order theory, a higher level of debt is highlighted during a financial crisis since firms become less profitable and tend to face liquidity issues which opens up for external financing (Cetorelli and Goldberg, 2011).The trade-off theory states that an optimal capital structure can be achieved by balancing the debt benefits with the debt costs (Kraus and Litzenberger, 1973; Myers, 1984).In case of financial crises, the bankruptcy risk arises which increases the debt costs. As such, the probability that the debt costs exceed the benefits of debt increases, which indicates that the trade-off theory argues for a decreased level of debt to avoid bankruptcy in cases of crises. In fact, because trade-off theory supports the benefits of debt, it also takes a standpoint that the tax advantages increase firm value and therefore assumes a positive relationship between leverage and firm performance.

The empirical studies show that there is an effect of capital structure on the financial performance of SME′s. However, there are contradictory studies, which justify further investigation. In addition, most of the published studies on Capital Structure and financial performance have been conducted in developed countries and large companies, where there is development in the capital markets (Kajirwa, 2019). The capital market in Uganda is relatively of low development and, therefore, the traditional theories of capital structure that originated in developed countries and large companies need to be tested in developing countries and in different companies both Small and Large Firms.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

In this chapter, the methods that were used in data collection, analysis and presentation are presented. It therefore provides a description of research design, study population and sample size, sampling methods, data collection instruments, data collection procedure, data quality control (reliability and validity), data analysis, ethical considerations and anticipated study limitations of the study as explained below.

3.2 Research Design

The research design used in this study was correlational. Correlational research is a type of non-experimental research in which the researcher measures two variables and assesses the statistical relationship (i.e. The correlation) between them with little or no effort to control extraneous variables (Messerli, F. H. (2012. In this study, correlational design was undertaken because there was a need to examine the relationship between Capital Structure and Financial Performance. The researcher used quantitative and qualitative approaches to support the collection of data from the field. Combining the qualitative and quantitative approaches enabled the researcher to gather in depth explanation in the case of qualitative approach.

3.3 Study Population

The researcher obtained information from small and medium enterprises owners in Kabale Municipality, Kabale district. The researcher involved small and medium enterprises owners because she believed they possessed the necessary information for study. The total number of the study population was (2,889) licensed small and medium enterprises in Kabale District. (Uganda Bureau of Statistics, Census of Business Establishments, 2010/11).

Table 3.1: Showing Study Population of SMEs in Kabale Municipality

Category	**Study population**
Agricultural Products	17
Forestry	2
Fishing	24
Mining & Quarrying	10
Food Processing	27
Other manufacturing	164
Utilities	2
Construction	2
Trade- General Merchandise	1785
Accommodation & Food Services	462
Information &Communication	28
Real Estates &Business	51
Education, Health & Social Services	60
Recreation & Personal	237
Total	**2,887**

Source: Uganda Bureau of Statistics, Census of Business Establishments, 2010/11)

Table 3.2: Showing Sample Size

Category	**Study Population**	**Sample size**
Food Processing	27	11
Accommodation & Food Services	462	192
Education, Health & Social Services	60	22
Total	**549**	**225**

Source: Uganda Bureau of Statistics, Census of Business Establishments, 2010/11)

3.4 Sampling Size

. The sectors considered were food processing, real estate, and accommodation and food services. According to Forte et al. (2013), due to the specific characteristics and the development cycle of SMEs, maintenance of authentic financial records is limited because of inadequate training of the entrepreneurs in bookkeeping and the cost attached to hiring professional accountants. The study prioritized data quality over quantity, selecting 225 firms with high-quality financial data, rather than risking errors or inconsistencies by including a larger sample size. The researcher therefore used the sample size of 225 respondents that was selected from the study population because in their nature, records are kept and so will help the researcher to obtain more and reliable information for the study.

3.5 Sampling Methods

Kothari (2004) defines sampling as the process of selecting a sample from a population. Researchers select a sample due to various limitations that may not allow researching the whole population (Mugenda & Mugenda, 2003). The sampling techniques used included both random sampling to get the sample from the population of 540 and purposive sampling for information from Managers of SME's during the process of data collection from the study respondents.

3.6 Data Collection Instruments

Questionnaire: The questionnaire tool was close ended in nature and this was self-administered where the researcher had to fill the questionnaire in the study field as per respondents' responses. The researcher used closed questions in her questionnaire tool. It was a likert scale questionnaire with; 5= Strongly agree, 4= Agree, 3=Not sure, 2 Disagree and 1=Strongly Disagree. In this way, the closed questionnaire with a list of possible options or answers from which the respondents must choose was used. This tool collected data from small and medium enterprises owners in the study area. The questionnaire method of data collection was used because of being cheap and that the method collects responses with minimum errors and high level of confidentiality.

Interview guide: The interviewing guide was also used with the help of an interview guide to capture data from respondents. The interview guide had open ended questions which were guided by the study objectives and collected data from people in commercial office at Kabale Municipality**.**

3.7 Data Gathering Procedures

The study observed all those procedures followed in research. Using the letter of introduction obtained from the Faculty of Business and Administration −Uganda Christian University (UCU), the researcher was introduced to every respondent reached at during data collection in Kabale Municipality, fully explaining the purpose of research. After getting their consent, the researcher conducted the research. The researcher also built the confidence of the respondents by assuring them that their views would be confidential and would be used only for academic purposes.

3.8 Reliability and Validity of Instruments

3.8.1 Reliability of Instruments

According to Amin (2005), reliability of an instrument refers to the extent to which the research instruments are without bias, thus, presenting consistent measurements especially in data collection process. To ensure reliability for interview guides, recorded interviews, extensive interview notes and field notes were ensured so as determine reliability. These processes highlighted potential problems and areas that might have been omitted. The pre-test was employed to contribute to the credibility, dependability and trustworthiness of a questionnaire. The findings from the test-retest were coded in the Special Package for Social Scientists (SPSS), a computer package to test for reliability at the Cronbanch's alpha coefficient of 0.7 to assess the internal consistency and the findings regarding these are presented in Table 3.3.

Table 3.3: Results of Reliability Test

Variable	Anchor	Cronbach Alpha Value
Debt Capital	5-Point	.8703
Equity Capital	5-Point	.8134

Retained Earnings	5-Point	.8624
Financial performance	5-Point	.8012
Overall Average		**.8368**

Source: Pilot Research, 2020

As it can be seen from Table 3.3, the overall average of Cronbanch Alpha Coefficients for all the items in the questionnaire measured .8368 which is greater than the standardized Cronbanch Alpha Coefficient of 0.7 thus, the instruments used in this study were reliable.

3.8.2 Validity of the Instruments

As for the validity of the instrument, expert judgment was used. In this regard, two experts in instrumentation were asked to determine the content of the research instruments and after which Content Validity Index (CVI) was computed at the estimated alpha coefficient of 0.70. The findings from the two experts were used to establish content validity index as shown in Table 3.4.

Table 3.4: Validity Test Results

	Relevant items	**Not relevant items**	**Total**
Rater 1	28	2	30
Rater 2	27	3	30
Total	**55**	**05**	**60**

$$\boldsymbol{CVI} = \frac{\text{RelevantItems}}{\text{TotalNumberofItems}} = \frac{\mathbf{55}}{\mathbf{60}} = \mathbf{0.917}$$

Thus, since the CVI computed was 0.917 and this was above 0.7, the standard cronbanch alpha, the instruments were considered valid this is also in line with Amin (2005) who noted that the overall CVI for the instrument should be calculated by computing the average of the instrument and for the instrument to be accepted as valid the average index should be 0.70 or above.

3.9 Data Analysis

The filled questionnaires were edited one by one to correct errors that would be done by the respondents. Data was edited in order to check for accuracy, completeness, consistency and uniformity. Data contained in the questionnaires were coded and entered into the computer for analysis. The Statistical Package for Social Sciences (SPSS) programme Version 20.0 was employed in the analysis as the program is assumed to enable the researcher to complete her research successfully as frequency distribution tables and figures were developed to summarise the demographic characteristics. Pearson' correlation of coefficient was used to establish the relationships between capital structures and financial performance. Multiple Regression analysis was used to determine how the predictor variables could explain the dependent variable. This was because there was more than one variable affecting the dependent variable. Qualitative data will be analyzed manually and notes written.

3.10 Ethical Considerations

The researcher sought ethical approval from Faculty of Business and Administration −Uganda Christian University (UCU) to protect the human participants in the study against any adverse effects during the study and ensuring confidentiality and anonymity of the study participants.

Furthermore, all the study participants were asked to give written consent before they were recruited to participate in the study.

CHAPTER FOUR

PRESENTATIONS AND ANALYSIS OF DATA

4.1 Introduction

This chapter presents the results of the study, their interpretations and discusses them. It includes; the demographic characteristics of respondents, findings regarding the extent to use various constructs on capital structures in the selected SMEs in Kabale Municipality; then the level of financial performance among the selected SMEs in Kabale Municipality; followed by the effect of debt capital on financial performance; next is the effect of equity capital on financial performance; and lastly, the effect of retained earnings on the financial performance of selected SMEs in Kabale Municipality was established.

4.2 Response Rate

The study sought to address the objectives by administering a questionnaire to respondents and analyzing it. Out of the 225 respondents to whom the questionnaire was administered, 225 respondents filled and returned the questionnaires to the researcher. This represented 100% response rate, and which is more than sufficient enough from which to draw conclusions upon. Mugenda and Mugenda (2003) declares 50% and above response rate as being satisfactory to use in concluding upon. The study considers a 75% response rate as adequate, 60% and above as good, while 70% and above is rated very good. Similar sediments are shared by Babbie (2010)

asserted that return rates of above 50% are acceptable to analyze and publish, 60% is good and 70% is very good. This means that the response rate for this study being 100% was very good.

4.3 Demographic Characteristics of Respondents

The socio-demographic characteristics of respondents in this study included the age, gender, marital status, education level, positions or roles in the business, number of years in the business, and source of business funding. The findings regarding these are presented in the following Tables and Figures.

4.3.1. Respondents' Age

The study sought to know the distribution by age of the respondents involved in the study. The study yielded the results as presented in Table 4.1.

Table 4.1: Age-Based Distribution of Respondents

Age Group of respondents	Frequency	Percentage
18-25	25	11.1
26-30	15	6.7
31-35	43	19.1
36-40	54	24.0
40 and above	88	39.1
Total	**225**	**100.0**

Source: Primary Source, 2021

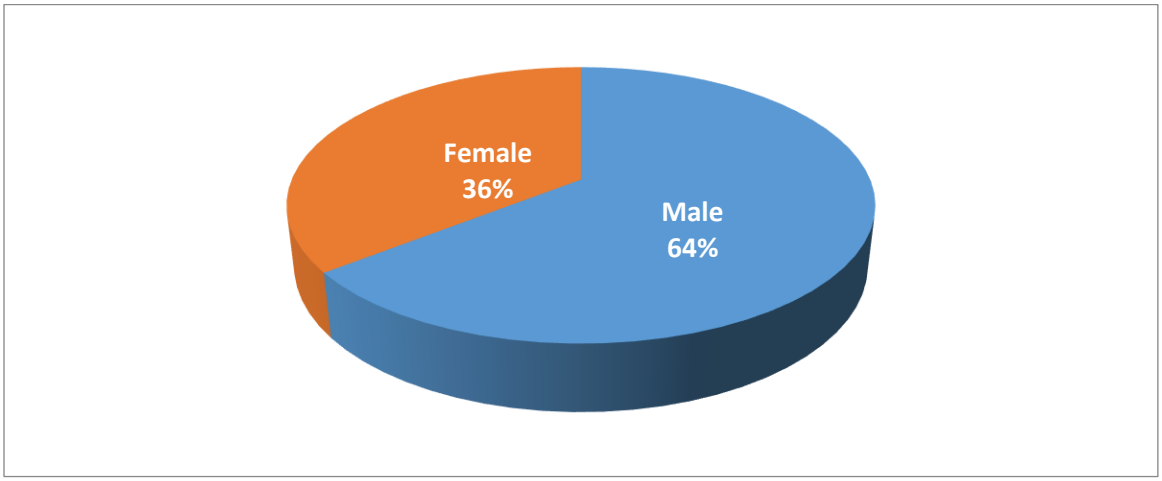
As Table 4.1 summarizes, the study revealed that of the 225 respondents who participated in this study, 11.1% of the respondents were aged between 18 and 25 years old, 6.7% of the respondents were aged between 26 and 30 years old, 18.7% of the respondents were aged between 31 and 35 years, 23.6 of the respondents were between 36 and 40 years while only 39.1% of the respondents were over 40 years old. This shows that those 40 years and above were the highest respondents

with 39.1%. since over 60% of the respondents were below 40 years, this suggests that most of the respondents were still in youthful age, and this could be so because youth now actively involve themselves in socio-economic activities thus could have formed a bigger percentage of SMEs in Kabale Municipality.

4.3.2. Gender of Respondents

The study determined the distribution of respondents by gender. This was with a view to determine whether both genders were well presented in SME's. The findings regarding these are presented in Figure 4.1.

Figure 4.1: Gender-Based Distribution of Respondents



Source: Primary Source, 2021

The findings in Figure 4.1 shows that that gender of SME's is unfairly skewed in favor of men in the sense that 64.4% of the respondents were males while only 35.6% of the respondents were females. This finding implies that SMEs are dominated by males. However, the research findings were not affected by the gender imbalance since the aspects under investigation were not gender biased. Selecting respondents from both genders helped in information complementation.

4.3.3 Marital Status of Respondents

The study wanted to know the distribution by Marital Status of the respondents involved in the study. This was with a view to determine whether all marital statuses are well presented in SME's. The findings revealed the following results in figure 4.3

Table 4.2: Distribution of Respondents by Marital Status

Marital status of respondent	Frequency	Percentage
Single	70	31.3
Married	76	33.9
Separated	43	19.2
Divorced	17	7.6
Widowed	18	8.0
Total	225	100.0

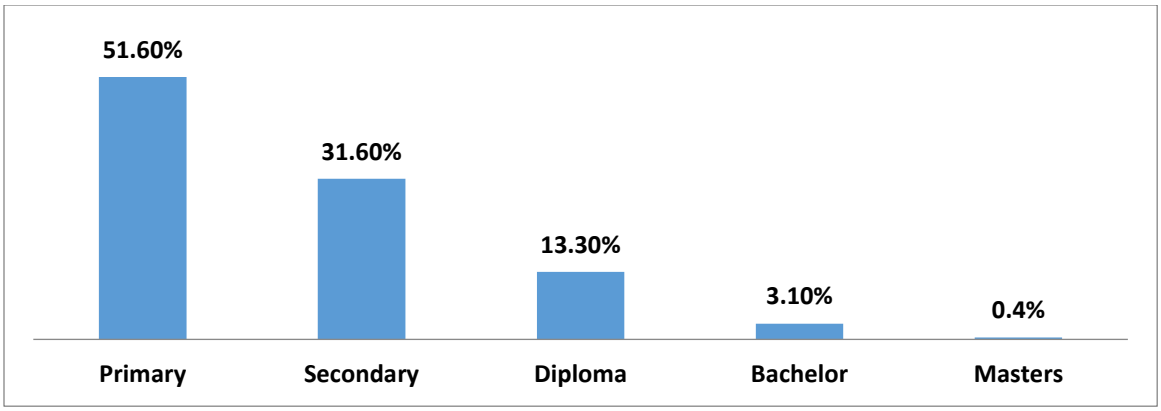
Source: Primary Source, 2021

The findings presented in Table 4.2 show that 31.3% of the respondents were single, 33.9% of participants were married; 19.2% of the respondents had separated, 7.6% of the respondents were divorced; and 8% of the respondents were widowed. This meant that the number of married respondents was higher than those in any other category. Considering people of different marital status as respondents in this study is important because the nature of capital structure employed by people of different marital status may vary and this may be influenced by the differences in their marital status thus, this was important for this study.

4.3.4 Level of Education

The research sought to know the highest level of education that respondents had attained before they got involved into SME's. This was aimed at determining whether the respondents had knowledge that can help them in running the business. The findings regarding these are presented as shown in Figure 4.2.

Figure 4.2: Distribution of Respondents Based on Education Level



Source: Primary Source, 2021

Figure 4.2 shows that out of the 225 respondents who participated in this study, 116 (51.6%) of the respondents had primary level of education, 71 (31.6%) of the respondents had attained secondary level of education; while 30 (13.3%) of the respondents had Diploma level of education; 7 (3.1%) of the respondents had Bachelors level of education, and only 1(0.4%) of the respondents had a master degree. This means that the majority (51.6%) of the respondents had Primary education as their highest level of education. This study collaborates with several other previous studies. For instance, Kamunge (2014) indicated that 93.5% of the respondents had at most secondary school level and below of education. Mutegi, Njeru and Nyamboga (2015) also noted that 86% entrepreneurs had secondary School level of education and below.

4.3.5. Position / Role in Business

The respondents were requested to show if they owned the business or not. The findings are summarized in Table 4.3 below.

Table 4.3: Distribution of Respondents by Position/Responsibilities in Business

Position or role in business	Frequency	Percent
Owner	105	46.7
Manager	68	30.2
Attendant	32	14.2
Other	20	8.9
Total	**225**	**100.0**

Source: Primary Source, 2021

The findings in Table 4.3 indicate that of the 225 respondents who participated in this study, 46.7% of the participants were the business owners, 30.2% of the respondents were the business Managers, 14.2% of them were the business attendants and the remaining 8.9% of the respondents were others such as relatives to the owners like children. This meant that the number of business owners was higher than any other category followed by the managers. This therefore means that most of the participants used in the study had first-hand knowledge of capital structure and financial performance concerns that were being asked herein the study. The researcher, however, noticed during the study that the ownership of the business as revealed herein is due to the involvement of the respondents in that given business.

4.3.6 Years of Operation

The study sought to know the year in which the enterprises were established. This was with a view to determine the number of years the enterprises have been in operation. The respondents gave their views as shown in Table 4.4.

Table 4.4: Distribution of Respondents by Year Business Was Started

Year business was started	Frequency	Percent	No of years
2019	11	4.9	1
2018	24	10.7	2
2017	20	8.9	3
2016	39	17.3	4
2015	46	20.4	5
2014 and before	85	37.8	6 and Above
Total	**225**	**100.0**	

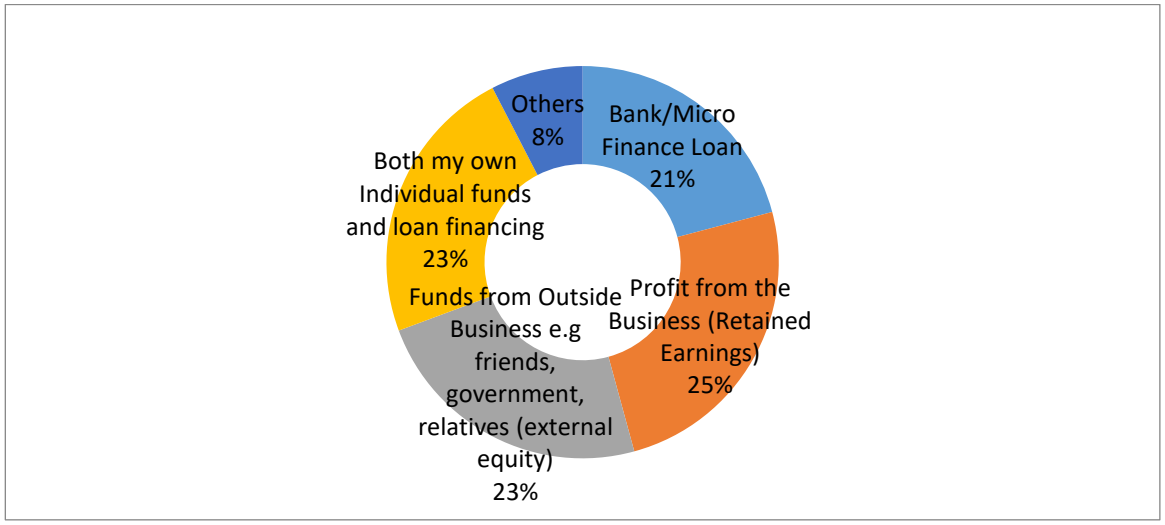
` Source: Primary Source, 2021

Results in Table 4.4 show that 11(4.9%) of the SME′s had been in operation for 1 year, 24 (10.7%) of the SMEs have been operating for 2 years, 20 (8.9%) of them have been operating for 3 years, 39 (17.3%) of them have been operating for 4 years, 45 (20%) of the SMEs have been operating for 5 years and 85(37.8) of them have been operating for 6 years and above. This implies that most of the respondents in the SME′s had been in existence for 6 years and above, while the mushrooming SMEs are still at a small percentage.

4.3.7 Source of Funding

The study sought to find out the status of financing for the SME's involved in the study. The findings regarding these are presented in Figure 4.3.

Figure 4.3: Distribution of Respondents by Source of Funding



Source: Primary Source, 2021

The results displayed in Figure 4.3 show that 21% of the respondents acquired loans either from banks or Micro Finances or SACCOs as their source of financing for their Businesses; 25.5% plough back profits from their businesses; 23% use equity financing as their source of business funding; 23% use a mixed funding that is both own individual funds and loan financing while the remaining 8% got their funding from other sources such as donations.

4.3.8 Reasons for Preferred Type of Funding Source

The reason for the preferred type of funding sources among SMEs was also investigated among the SMEs in Kabale Municipality and the results regarding these are presented in Table 4.5.

Table 4.5: Reasons for Preferred Source of Business Funding among SMEs

Position or role in business	Frequency	Percent
It is the cheapest form of funding	62	27.6
Easy to access	66	29.3

It was the only funding source available	61	27.1
It gives a relative higher return on investment	36	16.0
Total	**225**	**100.0**

Source: Primary Source, 2021

According to the findings presented in Table 4.5, out of the 225 SMEs selected for this study, 27.6% of them chose the preferred type of funding because it was the cheapest form; 29.3% of them preferred a particular type of funding source because it was easy to access, 27.1% of them chose a particular type of funding source because it was the only source of funding available; and 16% of the SMEs chose a particular type of funding source because it gives a relative higher return on investment.

4.4 Capital Structure among the Selected SMEs in Kabale Municipality

Before answering the research objectives, this study examined the extent to use various capital structures among SMEs in Kabale Municipality. The capital structures examined in this study included debt capital, equity capital and retained earnings. Mean values and standard deviations were used to determine the use of three capital structures. Mean ranges from 1.00-1.79 indicated that majority of the respondents strongly disagreed with the use of the particular capital structure, thus, the capital structure is very lowly used among the selected SMEs in Kabale Municipality; mean ranges from 1.80-2.59 show that majority of the respondents disagreed with the use of the particular capital structure, thus, the capital structure is lowly used among the selected SMEs in Kabale Municipality; mean ranges from 2.60-3.39 indicate that majority of the respondents were undecided about the items investigated under the use of the particular capital structure, thus, the capital structure is moderately used among the selected SMEs in Kabale Municipality; mean ranges from 3.40-4.19 show that majority of the respondents agreed with the use of the particular capital structure, thus, the capital structure is highly used among the selected SMEs in Kabale Municipality; and lastly; mean ranges from 4.20-5.00 portray that majority of the respondents strongly agreed with the use of the particular capital structure, thus, the capital structure is very highly used among the selected SMEs in Kabale Municipality. The findings regarding these are presented in Table 4.6.

Table 4.6 Mean Values Showing Debt Capital among SMEs in Kabale Municipality

DEBT CAPITAL	Mean	Std. Dev	SD%	D%	N%	A%	SA%	Interpretation
My firm makes regular monthly payments of principal and interest	3.45	1.35	11.1	15.6	19.6	24.9	28.9	Highly
I prefer Debt Capital so long as my business achieves relatively high profits	3.28	1.26	10.2	16.9	28.0	24.0	20.9	Moderate
We have used loan to expand our business compared to our capital	3.28	1.31	11.1	19.6	21.3	25.8	22.2	Moderate
Our business access loans and that has improved our operations	3.26	1.28	10.2	20.4	23.1	25.8	20.4	Moderate
Much of our funding in the business is from loan	3.22	1.28	14.2	13.8	24.4	31.1	16.4	Moderate
In the past years to date I have used debt funding in my business	3.18	1.42	16.4	19.6	17.8	22.2	24.0	'8 Moderate
Average Mean, Std. Dev and Percentages	**3.28**	**1.32**	**12.2**	**17.7**	**22.4**	**25.6**	**22.1**	**Moderate**

Source: Primary Data, 2021

Results in Table 4.6 indicate that employability of capital debt as capital structure among the SMEs in Kabale Municipality is rated moderate and this finding is supported by the average mean value of 3.28 that refers to moderate in the rating scale within standard deviation of 1.32. The moderate employability of capital debt as capital structure among the SMEs in Kabale Municipality is also supported by the average percentages for agreed items that stand at 47.7% (for both agreed and strongly agreed); and that of disagreed items that stand at 29.9% (for both disagreed and strongly disagreed). Since none of the sides (both agreed and disagreed) exceeds 50%, it can be confirmed that the employability of capital debt as capital structure among SMEs in Kabale Municipality is generally moderate.

The use of capital debt as capital structure among SMEs in Kabale Municipality is moderate because respondents moderately rated that they prefer debt capital so long as their businesses achieve relatively high profits (mean=3.28; Std. Dev=1.26); that they have used loan to expand their business compared to their capital (mean=3.28; Std. Dev=1.31); that their business access

loans and that has improved their operations (mean=3.26; Std. Dev=1.28); that much of their funding in the business is from loan (mean=3.22; Std. Dev=1.28); and that in the past years to date they have moderately used debt funding in their business (mean=3.18; Std. Dev=1.42).

However, respondents rated the employability of one of the items under debt capital highly as they agreed that their firms make regular monthly payments of principal and interest (mean=3.45; Std. Dev=1.35).

Table 4.7 Mean Values Showing Equity Capital among SMEs in Kabale Municipality

EQUITY CAPITAL	Mean	Std. Dev	SD%	D%	N%	A%	SA%	Interpretation
I have invested my personal funds into my businesses	3.68	1.33	10.2	10.7	16.4	26.7	36.0	Highly
Using personal funds in the business is much better than adding loans	3.43	1.42	14.2	13.8	17.8	23.1	31.1	Highly
We have used our own capital to expand our business	3.41	1.32	11.1	16.0	18.2	29.8	24.9	Highly
I have continued investing personal funds in the growth of our business	3.40	1.47	15.1	16.9	14.2	20.4	33.3	Highly
Our capital is not adequate to grow the business to where we want.	3.39	1.26	8.0	19.6	22.2	26.2	24.0	Moderate
Our capital level has limited our ability to make more business	3.38	1.26	8.9	18.2	20.9	30.2	21.8	Moderate
My relatives and friends, have helped me with the capital for my business	3.28	1.33	13.3	16.4	21.3	27.1	21.8	Moderate
The business has high returns because I don't have loans to repay	3.16	1.45	18.7	17.3	18.2	20.9	24.9	Moderate
Much of my finance used in the business is capital as opposed to loan	3.15	1.37	16.4	18.7	18.2	27.1	19.6	Moderate
I have sold my personal Asset to finance my business	3.08	1.34	15.1	21.8	20.4	24.9	17.8	Moderate
My business does not have any additional financial burden and obligation in form of interest	3.04	1.26	12.9	23.6	24.0	21.3	14.2	Moderate
Average Mean, Std. Dev and Percentages	**3.31**	**1.35**	**13.1**	**21.5**	**19.3**	**21.6**	**24.5**	**Moderate**

Source: Primary Data, 2021

Results in Table 4.7 show that the employability of equity capital as capital structure among SMEs in Kabale Municipality is generally moderate and this finding is confirmed by the average mean value of 3.18 that refers to moderate in the rating scale within standard deviation of 1.35. Furthermore, the employability of equity capital as capital structure among the SMEs in Kabale Municipality was moderate because the average percentages for agreed items stand at 46.1% (for both agreed and strongly agreed); and that of disagreed items stand at 34.6% (for both disagreed and strongly disagreed). Since none of the sides (both agreed and disagreed) exceeds 50%, it can be confirmed that the employability of equity capital as capital structure among SMEs in Kabale Municipality is generally moderate.

The employability of equity capital is moderately rated by majority of respondents because respondents stated that their capital is not adequate to grow the business to where they want (mean=3.39; Std. Dev=1.26); their capital level has limited their ability to make more business (mean=3.38; Std. Dev=1.26); that their relatives and friends, have helped them with the capital for their businesses (mean=3.28; Std. Dev=1.33); that their businesses have high returns because they don't have loans to repay (mean=3.16; Std. Dev=1.45); that much of their finances used in the business is capital as opposed to loan (mean=3.15; Std. Dev=1.37); that they have sold their personal assets to finance their businesses (mean=3.08; Std. Dev=1.34); and that their businesses do not have any additional financial burden and obligation in form of interest (mean=3.04; Std. Dev=1.26).

Nevertheless, respondents rated some items under the employability of equity capital highly among them because they agreed that they have invested their personal funds into their businesses (mean=3.68; Std. Dev=1.33); that using personal funds in the business is much better than adding loans (mean=3.43; Std. Dev=1.42); that they have used their own capital to expand their businesses (mean=3.41; Std. Dev=1.32); that they have continued investing personal funds in the growth of their businesses (mean=3.40; Std. Dev=1.47).

Table 4.8 Mean Values Showing Retained Earnings among SMEs in Kabale Municipality

RETAINED EARNINGS	**Mean**	**Std. Dev**	**SD%**	**D%**	**N%**	**A%**	**SA%**	**Interpretation**

We use our profits to acquire more assets in the business	3.73	1.41	10.7	13.8	9.8	23.1	42.7	Highly
We retain most of our profits in the business for expansion	3.56	1.26	9.3	10.2	23.1	29.3	28.0	Highly
We distribute much of our profits to the shareholders	3.49	1.33	10.7	16.4	13.3	32.4	27.1	Highly
We have been able to expand our operations due to reploughing back the profits into the business.	3.47	1.36	10.7	17.3	16.4	25.8	29.8	Highly
Average Mean, Std. Dev and Percentages	**3.56**	**1.34**	**10.4**	**14.5**	**15.7**	**20.5**	**31.9**	**Highly**

Source: Primary Data, 2021

Regarding the employability of retained earnings among the selected SMEs in Kabale Municipality as indicated in Table 4.8, this study found out that most of the SMEs in Kabale Municipality highly employ their retained earnings in business. This finding is supported by the average mean value of 3.56 that refers to high in the rating scale within the standard deviation of 1.34. This finding is again supported by the average percentage of agreed items (both strongly agreed and agreed) that stand at 52.4% suggesting that SMEs generally agreed that they highly employ their retained earnings in business.

The employability of retained earnings among the SMEs is highly rated because majority of the respondents agreed that they use their profits to acquire more assets in the business (mean=3.73; Std. Dev=1.41); they also agreed that they retain most of their profits in the business for expansion (mean=3.56; Std. Dev=1.26); they further agreed that they distribute much of their profits to the shareholders (mean=3.49; Std. Dev=1.33); and that they have been able to expand their operations due to reploughing back the profits into the business (mean=3.47; Std. Dev=1.36).

Your standard deviation values are questionable. You need to know that when the mean is above 3.5, SD values are in a certain range.
Your analysis is suspect.

4.5 The Financial Performance of Selected SMEs in Kabale Municipality

The financial performance of Selected SMEs in Kabale Municipality was the dependent variable of this study and was also examined before answering the research objectives. As it was in the case of the independent variable, mean ranges and standard deviations were used to assess the financial performance of the selected SMEs in Kabale Municipality. Mean ranges from 1.00-1.79 indicated

that majority of the respondents strongly disagreed with the items investigated under financial performance of Selected SMEs in Kabale Municipality, thus, the financial performance of the selected SMEs in Kabale Municipality is very low; mean ranges from 1.80-2.59 show that majority of the respondents disagreed with the items investigated under financial performance of Selected SMEs in Kabale Municipality, thus, the financial performance of the selected SMEs in Kabale Municipality is low; mean ranges from 2.60-3.39 indicate that majority of the respondents were undecided about the items investigated under the financial performance of Selected SMEs in Kabale Municipality, thus, the financial performance of the selected SMEs in Kabale Municipality is moderate; mean ranges from 3.40-4.19 show that majority of the respondents agreed with the items investigated under financial performance of Selected SMEs in Kabale Municipality, thus, the financial performance of the selected SMEs in Kabale Municipality is high; and lastly; mean ranges from 4.20-5.00 portray that majority of the respondents strongly agreed with the items investigated under financial performance of Selected SMEs in Kabale Municipality, thus, the financial performance of the selected SMEs in Kabale Municipality is very high. The findings regarding these are presented in Table 4.9.

Table 4.9: Mean Values Showing Financial Performance of Selected SMEs in Kabale Municipality

FINANCIAL PERFORMANCE	Mean	Std. Dev	SD%	D%	N%	A%	SA%	Interpretation
There has been an increase in Revenue in my business in the past years	3.74	1.23	4.4	16.9	13.8	29.8	35.1	High
The business is able and can easily pay her short term obligations and current liabilities	3.63	1.49	18.2	5.3	11.1	25.8	39.6	High
There has been an increase in Cash flow in my business in the last years to date	3.57	1.42	13.8	12.9	10.2	28.4	34.7	High
There has been increase in the employees in my business	3.56	1.35	12.0	13.3	10.2	35.6	28.9	High
There has been an increase in Net profit/ Net income (ie Sales Revenue less all Expenses related to the business) of my business in the last years to date	3.51	1.27	7.6	17.8	17.8	29.8	27.1	High
There has been an increase in the number of Customers/Clients of my business in the last years to date	3.51	1.35	12.9	10.7	17.8	30.2	28.4	High

There has been a gradual increase in the retained earnings over the last years to date.	3.47	1.3	11.6	14.2	14.2	35.6	24.4	High
There has been an increase in Net profit Margin (Net Profit/Revenue) of my business in the last years to date	3.45	1.25	8.9	15.6	20.4	31.6	23.6	High
The value of my business's total Assets has increased over the years	3.44	1.45	15.6	14.2	13.3	24.9	32.0	High
Average Mean, Std. Dev and Percentages	**3.54**	**1.35**	11.7	**13.4**	**14.3**	**31**	**30.4**	**High**

Source: Primary Data, 2021

Concerning the financial performance of the selected SMEs in Kabale Municipality, the findings in Table 4.9 indicate that the financial performance of the selected SMEs is generally high. This finding is confirmed by the average mean value of 3.54 that refers to high in the rating scale within the standard deviation of 1.35. This result is supported by the average mean value of 3.56 that refers to common in the rating scale within the standard deviation of 1.34. This finding is also supported by the average percentage of agreed items (both strongly agreed and agreed) that stand at 61.4% suggesting that SMEs agreed that their financial performance is generally high.

The financial performance of the selected SMEs in Kabale Municipality is generally high because respondents agreed that there has been an increase in revenue in their business in the past years (mean=3.74; Std. Dev=1.23); they also agreed that the business is able and can easily pay their short term obligations and current liabilities (mean=3.63; Std. Dev=1.49); they further agreed that there has been an increase in cash flow in their businesses in the last years to date (mean=3.57; Std. Dev=1.42); that there has been increase in the employees in their business (mean=3.56; Std. Dev=1.35); that there has been an increase in Net profit/ Net income (ie Sales Revenue less all Expenses related to the business) of their businesses in the last years to date (mean=3.51; Std. Dev=1.27); that there has been an increase in the number of Customers/Clients of their businesses in the last years to date (mean=3.51; Std. Dev=1.35); and that there has been a gradual increase in the retained earnings over the last years to date (mean=3.47; Std. Dev=1.3); that there has been an increase in Net profit Margin (Net Profit/Revenue) of my business in the last years to date (mean=3.45; Std. Dev=1.25); they continued to agree that the value of their business's total Assets has increased over the years (mean=3.44; Std. Dev=1.45).

4.6 Research Objectives

4.6.1 Objective 1: The Effect of Debt Capital on Financial Performance of Selected SMEs in Kabale Municipality

The first research objective of this study was to examine the effect of debt capital on the financial performance of selected SMEs in Kabale Municipality. To establish the relationship between debt capital and financial performance of Selected SMEs in Kabale Municipality, a Pearson correlation was employed, and the findings are established in Table 4.10.

Table 4.10: Relationship between Debt capital and Financial Performance of Selected SMEs in Kabale Municipality

		Debt Capital	Financial Performance
Debt Capital	Pearson Correlation	1	.391**
	Sig. (2-tailed)		.000
	N	225	225
Financial Performance	Pearson Correlation	.391**	1
	Sig. (2-tailed)	.000	
	N	225	225
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Primary Data

The findings presented in Table 4.10 indicate that there is a positive and significant relationship between effective use of debt capital and financial performance of Selected SMEs in Kabale Municipality. This finding is indicated in the r. value of 0.391** and significant value of 0.000. This finding implies that any unit improvement in effective use of debt capital in Selected SMEs in Kabale Municipality can lead to improvement in the selected SME's level of financial performance by 39.1 %, thus, the remaining 60.9% improvement in financial performance can be explained by other capital structures.

4.6.2 Regression Analysis between the Debt Capital and Financial Performance

To verify the research findings obtained through correlation, multiple regression analysis: through the model summary and the regression coefficients were employed and the findings regarding these are presented in Table 4.11 and 4.12.

Table 4.11: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.391[a]	.153	.149	.89507
a. Predictors: (Constant), **Debt Capital**				

Source: Primary Data, 2021

The model summary in Table 11 shows the R. Square and this tells us that 15.3 percent of the observed variability in the financial performance of selected SMEs in Kabale Municipality is explained by the independent variable which is debt capital. R. value of 0.391[a] is the correlation coefficient between the observed value of independent variable and the predicted value based on the regression model. A value close to zero tells that the independent variable is not linearly related to the dependent variable. Since the observed R. Value is relatively high at 0.391[a], this indicates that the linear regression model fits well. The adjusted R. Square (0.149) is the proportion of the variability in the dependent variable explained by the linear regression.

Table 4.12: Regression Coefficients between Debt Capital and Financial Performance of Selected SMEs in Kabale Municipality

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.267	.210		10.805	.000
	Debt Capital	.389	.061	.391	6.339	.000
a. Dependent Variable: **Financial Performance**						

Source: Primary Data, 2021

The research findings in Table 4.12 clearly confirms that effectiveness in the use of debt capital, has positive and significant relationship with level of financial performance among selected SMEs

in Kabale Municipality and this finding is demonstrated in the β value of 0.391at significant value of 0.000 for debt capital within the standardized significant value of 0.05. Therefore, it can be said that effectiveness in the use of debt capital among SMEs in Kabale Municipality will significantly boost their financial performance by 39.1%.

4.7.1 Objective 2: The Effect of Equity Capital on Financial Performance of Selected SMEs in Kabale Municipality

The second research objective of this study established the effect of equity capital on financial performance of the selected SMEs in Kabale Municipality. To establish the correlation between the variables, a Pearson correlation was also used and the findings regarding these are presented in Table 4.13.

Table 4.13: Correlation between Equity Capital and Financial Performance of the Selected SMEs in Kabale Municipality

		Equity Capital	Financial Performance
Equity Capital	Pearson Correlation	1	.411**
	Sig. (2-tailed)		.000
	N	225	225
Financial Performance	Pearson Correlation	.411**	1
	Sig. (2-tailed)	.000	
	N	225	225
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Primary Data

From the findings presented in Table 4.13, it can be noted that any variation in the use of equity capital will lead to a positive and significant variation in financial performance among the SMEs in Kabale Municipality. This finding is supported by the Pearson Correlation value (r) of 0.411**and significant value of 0.000 which is far less than the standardized significant value 0.05. This finding means that any unit improvement in the effective use of equity capital in Selected SMEs in Kabale Municipality can lead to improvement in the SME's level of financial performance by 41.1 %. In this case it can be said that the remaining 58.9% of the variability can be explained by the other capital structures other than equity capital.

4.7.2 Regression Analysis between the Equity Capital and Financial Performance

To verify the research findings obtained on the correlation between equity capital and financial performance among SMEs in Kabale Municipality, multiple regression analysis: through the model summary and the regression coefficients were also used and the results concerning these are presented in Table 4.14 and 4.15.

Table 4.14: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.411[a]	.169	.165	.88662
a. Predictors: (Constant), **Equity Capital**				

Source: Primary Data, 2021

The model summary presented in Table 4.14 again illustrates the R. Square and this notifies us that 16.9 percent of the observed variability in the financial performance of the selected SMEs in Kabale Municipality is explained by the independent variable which is effective use of equity capital. R. value of 0.411[a] is the correlation coefficient between the observed value of independent variable and the predicted value based on the regression model. As it was indicated in the first objective, a value close to zero tells that the independent variable is not linearly related to the dependent variable. As the observed R. Value is quiet high at 0.411[a], this indicates that the linear regression model fits well. The adjusted R. Square (0.165) is also the proportion of the variability in the dependent variable explained by the linear regression.

Table 4.15: Regression Coefficients between Capital Equity and Financial Performance of the Selected SMEs in Kabale Municipality

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.830	.261		7.001	.000
	Equity Capital	.518	.077	.411	6.725	.000
a. Dependent Variable: **Financial Performance**						

Source: Primary Data, 2021

The results in Table 4.15 firmly show that, effective use of equity capital has positive and significant relationship with level of financial performance among the selected SMEs in Kabale Municipality. This result can be supported by the β value of 0.411 at significant value of 0.000 for equity within the standardized significant value of 0.05. In this case, it can be confirmed that any unit improvement in the effective use of equity capital among the selected SMEs in Kabale Municipality can lead to significant improvement in the financial performance on the SMEs.

4.8.1 Objective 3: The Effect of Retained Earnings on Financial Performance of Selected SMEs in Kabale Municipality

The last specific objective in this study sought to find out the effect of retained earnings on financial performance among the selected SMEs in Kabale Municipality. As it was in the case of the first two research objectives, this research objective was established using a Pearson correlation at the standardized significant value of 0.05. The findings regarding these are presented in Table 4.16.

Table 4.16: Effect of Retained Earning on the Financial Performance of the Selected SMEs in Kabale Municipality

		Retained Earnings	Financial Performance
Retained Earnings	Pearson Correlation	1	.698**
	Sig. (2-tailed)		.000
	N	225	225
Financial Performance	Pearson Correlation	.698**	1
	Sig. (2-tailed)	.000	
	N	225	225
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Primary Data, 2021

Taking into consideration the significant values presented in Table 4.16 respect to the standardized significant value of 0.05, it can be noted that effectiveness in the employability of retained earnings can significantly and positively impact on the financial performance of the selected SMEs in

Kabale Municipality. This finding is supported by the significant value of 0.000 and the Person Correlation of 0.698**. This finding means that the financial performance of the selected SMEs in Kabale Municipality will be boosted by 69.8% in every unit improvement in the effective use of retained earnings among the selected SMEs in Kabale Municipality.

4.8.2 Regression Analysis between the Retained Earnings and Financial Performance

To verify the research findings obtained through correlation between retained earnings and the financial performance among the selected SMEs in Kabale Municipality, multiple regression analysis: through the model summary and the regression coefficients were again employed and the findings regarding these are presented in Table 4.17 and 4.18.

Table 4.17: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.698[a]	.487	.484	.69672
a. Predictors: (Constant), **Retained Earnings**				

Source: Primary Data, 2021

The model summary presented in table 4.17 shows the R. Square and this means that 48.7 percent of the observed variability in the financial performance of the selected SMEs in Kabale Municipality is explained by the independent variable which is effective use of retained earnings. R. value of 0.698[a] is the correlation coefficient between the observed value of independent variable and the predicted value based on the regression model. In a similar way, a value close to zero tells that the independent variable is not linearly related to the dependent variable. In this regard, as the observed R. Value is quite high at 0.698[a], this indicates that the linear regression model fits well. The adjusted R. Square (0.484) is the proportion of the variability in the dependent variable explained by the linear regression.

Table 4.18: Regression Coefficients between Retained Earnings and Financial Performance of Selected SMEs in Kabale Municipality

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.182	.169		6.999	.000
	Retained Earnings	.662	.046	.698	14.539	.000
a. Dependent Variable: **Financial Performance**						

Source: Primary Data, 2021

The research findings in Table 4.18 clearly indicate that retained earnings as elements of capital structure have positive and significant relationship with level of financial performance and this finding is shown in the β value of 0.698 at significant value of 0.000. Considering the R. values in the correlation and model summary and the β value of 0.698, it can be ascertained that effective use of retained earnings alone can significantly boost financial performance among SMEs by 69.8% and the remaining 30.2% can be explained by other capital structures other than retained earnings.

Considering the effect of three constructs under capital structure (debt capital, equity capital and retained earnings) on financial performance individually, it can be said that the capital structure with the highest effect on financial performance among SMEs in Kabale Municipality is retained earnings that has the highest r. and β values at 0.698; this is followed by equity capital whose r. and β values stand at 0.411; and the capital structure with the least influence on financial performance among the SMEs in Kabale Municipality is the debt capital as its r. and β values stand at 0.391. In this case, it can be said that SMEs need to focus more on the use retained earnings if they need to boost their financial performance more though the rest of the other capital structures can play a vital role in boosting financial performance of the SMEs.

Multiple Regression Analysis between Capital Structures and Financial Performance

To find out the individual contribution of each construct under capital structures and financial performance, a multiple regression analysis: through the model summary; ANOVA and the regression coefficient were employed and the findings regarding these are presented in the following Tables.

Table 4.11: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.727[a]	.529	.523	.67018
a. Predictors: (Constant), Retained Earnings, Debt Capital, Equity Capital				

Source: Primary Data, 2021

The model summary shows the R. Square, and this tells us that 52.9 percent of the observed variability in the financial performance of Selected SMEs in Kabale Municipality is explained by the independent variable which is capital structures as regards to retained earnings, debt capital, equity capital. R. value of 0.727[a] is the correlation coefficient between the observed value of independent variable and the predicted value based on the regression model. A value close to zero tells that the independent variable is not linearly related to the dependent variable. Since the observed R. Value is relatively high at 0.727[a], this indicates that the linear regression model fits well. The adjusted R. Square (0.523) is the proportion of the variability in the dependent variable explained by the linear regression. Thus, the adjusted R. Square (0.523) which is a coefficient of determination implies that 52.3 percent of the financial performance of the selected SMEs in Kabale is explained by the capital structures such as retained earnings, debt capital and equity capital. According to the study, 47.7% of the financial performance is explained by other factors not investigated in this study.

Table 4.7: The ANOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	111.592	3	37.197	82.820	.000[b]
	Residual	99.259	221	.449		
	Total	210.852	224			

a. Dependent Variable: Financial Performance
b. Predictors: (Constant), Retained Earnings, Debt Capital, Equity Capital

Source: Primary Data, 2021

The Analysis of the Variance (ANOVA) was used to test the equivalent assumption that stated that there is significant relationship between the retained earnings, debt capital, equity capital and financial performance among the selected SMEs in Kabale. The assumptions are tested at the F=82.820, p<0.000 and from this it can be said that the assumptions that have been stated are accepted. This study implies that when other factors are kept constant, improvement in the use of capital structures such as retained earnings, debt capital and equity capital will significantly lead to improvement in financial performance among the selected SMEs in Kabale.

Table 4.12: Multiple Regression Analysis between Capital Structures and the Financial Performance of Selected SMEs in Kabale Municipality

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.602	.228		2.637	.009
	Debt Capital	.205	.048	.206	4.228	.000
	Equity Capital	.053	.068	.042	.777	.043
	Retained Earning	.587	.052	.619	11.394	.000
a. Dependent Variable: Financial Performance						

Source: Primary Data, 2021

The research findings in the above Table clearly indicate that individually, effectiveness in the use of debt capital and retained earnings as elements of capital structure have positive and significant relationship with level of financial performance among the selected SMEs in Kabale Municipality and this finding is shown in the β value of .206 at significant value of 0.000 for debt capital; β value of .619 at significant value of 0.000 for retained earnings.

However, the statistical illustration in the regression analysis suggests that Equity Capital has a weak association with financial performance among the selected SMEs in Kabale Municipality. This finding is demonstrated by very low β value of .042 and the significant value of .043 which is very close to the standardized significant value of 0.05.

This research finding established through multiple regression coefficients reveals that effectiveness in the use of retained earnings is the most important form of capital structure as regards to its role in improving the level of financial performance among the selected SMEs in Kabale Municipality.

The research findings on the relationship between effectiveness in the use of capital structures and financial performance among the selected SMEs in Kabale Municipality has led to the acceptance of the assumptions that effectiveness in the use of debt capital, equity capital and retained earnings among the selected SMEs in Kabale Municipality have positive and significant relationship with financial performance. The summary on the findings derived from the multiple regression analysis are presented in Table below.

Table 4.9: Summary on the Findings Derived from the Multiple Regression Analysis

Statements	**Beta Values**	**Sig. Values**	**Decision Taken**
Debt capital is positively related to financial performance of among SMEs in Kabale Municipality	.206	.000	Accepted
Equity Capital is positively related to financial performance among SMEs in Kabale Municipality	.042	.043	Accepted
Retained Earnings are positively related to financial performance among SMEs in Kabale Municipality	.619	.000	Accepted

4.9 Conclusion

From the descriptive statistics using mean and standard deviation, this study found out that the use of debt capital and equity capital among the SMEs in Kabale Municipality remains at moderate level. However, the majority of the SMEs highly use their retained earnings to boost their businesses. The general impression from the correlation (using r. values and significant values) and regression analysis (using Beta values and significant values) indicate that effective use of debt capital, equity capital and retained earnings can significantly lead to improvement in the financial performance of SMEs in Kabale Municipality. However, the type of capital structure

with the highest influence on financial performance is retained earnings, followed by the equity capital and then, debt capital. The next chapter establishes the discussions of the key findings; it draws conclusions as well as forwards relevant recommendations to improve usability of various capital structures to improve on the financial performance of SMEs in Kabale Municipality and those others across the country.

CHAPTER FIVE
SUMMARY AND DISCUSSION OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses the key research findings, draws conclusions and presents recommendations and these are presented objective by objective. Thus, it begins with the summary and the discussions of the findings on the effect of debt capital on financial performance among the SMEs in Kabale Municipality; then the effect of equity capital on financial performance among SMEs in Kabale Municipality; lastly, the effect of retained earnings on financial performance among SMEs in Kabale Municipality is established.

5.2 Summary and Discussion of Findings

5.2.0 Summary of the findings

According to the research findings, there is a significant relationship between capital structure and financial performance among SMEs in Kabale Municipality-Uganda. This study found out that there is a positive and significant relationship between effectiveness in debt capital and financial performance, that any unit improvement in effective use of debt capital among the selected SMEs, can lead to improvement in the level of financial performance among SMEs. The study also found out that any variation in equity capital implementation will lead to a positive and significant variation in financial performance. This finding suggests that any unit improvement in effectiveness in equity capital, can lead to improvement in the level of financial performance. This study also found out that effective use of retained earnings can significantly and positively impact on financial performance of the selected SMEs in Kabale Municipality. This study also found out, that the financial performance of the SMEs, will be boosted by 69.8% in every unit improvement in the effective use of retained earnings.

5.2 Discussion of the Findings

5.2.1 The Effect of Debt Capital on Financial Performance among SMEs in Kabale Municipality

The study found out that there is a positive and significant relationship between effectiveness in debt capital and financial performance of selected SMEs in Kabale Municipality. The relationship between the two variables is supported by the r. value of $0.391^{**}$and significant value of 0.000. This finding implies that any unit improvement in effective use in debt capital among the selected SMEs in Kabale Municipality can lead to improvement in the level of financial performance among SMEs in Kabale by 39.1 %.

Similarly, the regression coefficient results also confirm that effective use in the debt capital will have positive and significant impact on the financial performance of selected SMEs in Kabale Municipality. This finding was justified by the β value of 0.391^{**}at significant value of 0.000 for debt capital which is far less than the standard significant value of 0.05.

5.2.2 The Effect of Equity Capital on Financial Performance of the Selected SMEs in Kabale Municipality

On the correlation between equity capital and financial performance of the selected SMEs in Kabale Municipality, this study found out that any variation in equity capital implementation will lead to a positive and significant variation in financial performance. This finding is confirmed by the Pearson Correlation value (r) of 0.411^{**} and significant value of 0.000 which is far less than the standardized significant value 0.05. This finding suggests that any unit improvement in effectiveness in equity capital among the selected SMEs in Kabale Municipality can lead to improvement in the level of financial performance by 41.1 %.

The research findings obtained through regression coefficient also shows that effective use of equity capital as a construct of capital structures can lead to improvement of financial performance among the selected SMEs in Kabale Municipality. This finding was also supported by the β value

of 0.411 at significant value of 0.000 for equity capital which is far less than the standard significant value of 0.05.

5.2.3 The Effect of Retained earnings on Financial Performance of the Selected SMEs in Kabale Municipality

Finally, on the effect of retained earnings on the financial performance of the selected SMEs in Kabale Municipality, this study found out that effective use of retained earnings can significantly and positively impact on financial performance of the selected SMEs in Kabale Municipality. This finding is supported by the significant value of 0.000 and the Person Correlation of 0.698^{**}. This finding means that the financial performance of the selected SMEs in Kabale Municipality will be boosted by 69.8% in every unit improvement in the effective use of retained earnings among SMEs.

Similarly, the regression analysis through regression coefficient shows that retained earnings is positively and significantly related to the level of financial performance of the selected SMEs in Kabale Municipality. This finding is confirmed by the β value of 0.698^{**}at significant value of 0.000 at standardized significant value of 0.05.

5.3 Discussion of the Results

5.3.1 The Effect of Debt Capital on Financial Performance among SMEs in Kabale Municipality

The positive and significant findings on the effect of debt capital on financial performance in selected SMEs in Kabale Municipality agreed with the one by Akisimire (2019) who found that using debt capital is advantageous to business owners because of the effect of financial leverage in a study carried in western Uganda (2019) SMEs in relation to financial management. Additionally, as noted by the findings of Di Tomaso and Dubbini (2015) whose studies pointed out that using debt capital helps lower a business's taxes because of allowable interest deductions in a study carried out in 2015, they both attributed to cost on debt being tax deductible thus lowering tax liability

5.3.2 The Effect of Equity Capital on Financial Performance of the Selected SMEs in Kabale Municipality

The study found that there was positive and significant effect of equity capital on the financial performance among SMEs in Kabale Municipality The study findings in case of SMEs in Kabale is in agreement with the one by Kongmanila and Kimbara (2017) and Njagiet (2017) whose finding indicate that equity capital is derived from retained profits, own savings, contribution from friends, contribution from partners, deferred income, cash flow of the business, group of individuals, it can financially support the firm because they have high belief that the business will have high growth and returns.

The study findings of the effect of equity capital on financial performance among SMEs in Kabale Municipality is also in agreement with the one by Githire& Muturi (2015) whose studies also indicate that equity financing ensures that SMEs have full control, and the equity holders have to ensure that resources are allocated efficiently, hence increasing financial performance.

The above findings can be supported by the observations made by Kepha and Muturi (2013), who noted that most SMEs are financed by the proprietors and their relations. Thus, they usually don't prefer access to external finance since this implies reduction in freedom in managing the firm hence SMEs use equity financing to retain control and independence. In addition, it's argued that equity financing is said to have less risk since no fixed monthly loan repayments to make.

Consistent with the studies by Farna and French (2018), the study findings on the effect of equity capital on the financial performance of selected SMEs in Kabale Municipality also found out that using equity, on the other hand, the more profits a firm makes, the more it must share with equity investors. In this regard, the two studies point out that to take advantage of such equity capital-financing feature, the firm will often use equity capital to finance stable business operations they do not affect the controlling power of the owner-managers neither do they impose financial costs to the firm.

5.2.3 The Effect of Retained earnings on Financial Performance of the Selected SMEs in Kabale Municipality

The regression analysis through regression coefficient shows that retained earnings are positively and significantly related to the level of financial performance of the selected SMEs in Kabale Municipality.

This finding is in tandem with the studies undertaken by Abdulsaleh & Worthington, 2013 whose studies indicated that retained earnings play a crucial role in evaluating the shareholders' enrichment in the long run. Through retained earnings, shareholder's device the managers' ability of utilizing the amount of retained earnings effectively to improve the market value of the firm.

The study findings on the effect of retained earnings on the financial performance among the selected SMEs in Kabale Municipality is also in agreement with the one by Wang (2013) and Kinyua (2014) whose study findings indicted that the retained earnings significantly influence the market price of shares in the long run. The two studies also proved that both the dividends and retained earnings explain significant variations in share prices, given that the market assigns more weight for retained earnings in the long run. The study by Matovu (2015) also agrees that SME performance fairly relies on sales and profitability with sales being the greatest contributing factor followed by profitability. Furthermore, the performance of SMEs is above average indicating that SMEs can sustain themselves in the market through profitability and sales.

Since the study findings on the effect of retained earnings on the financial performance among the selected SMEs in Kabale Municipality found out that retained earnings lead to higher financial performance among selected SMEs, this is consistent with the study findings by Royer (2017) pointed out that firms with high marginal tax rates mostly benefit from equity capitalization where retained earnings constitute a greater part of the profits.

Similarly, the study findings on the effect of retained earnings on the financial performance among the selected SMEs in Kabale Municipality is also in line with the one by Hardiningsih and

Oktaviani (2012) who found out that high-growth companies would increase the use of internal funds for financing the growth.

Furthermore, the study findings on the effect of retained earnings on the financial performance among the selected SMEs in Kabale Municipality is also in agreement with the one by Jensen and Meckling (1976) and Edim Atseye (2014) who pointed out that firms with great growth potential would reduce the dependence on debt, as creditors would normally demand a higher return on their investments when firms intend to invest in risky projects.

These studies reviewed in the literature could agree with the one carried out in case of selected SMEs in Kabale Municipality because retained earnings is effective to the firms' performance in that it has not cost of issue, and it is a very flexible means of finance. In this case, the firm has nothing to worry about the repayments and defaults on repayments. It could also be said that the retained earnings as a financing source are effective because there is no change in the pattern of shareholding and dilution in the voting power of shareholders. Therefore, more profitable firms have a lower leverage ratio than less profitable firms as they can finance their investment opportunities with the retained earnings.

5.3.4 The effect of capital structure in financial performance of SMEs in Kabale

The study found out that individually, effectiveness in the use of debt capital and retained earnings as elements of capital structure have positive and significant relationship with level of financial performance among the selected SMEs in Kabale Municipality. However, the statistical illustration in the regression analysis suggests that Equity Capital has a weak association with financial performance among the selected SMEs in Kabale Municipality.

This research finding established through multiple regression coefficients reveals that effectiveness in the use of retained earnings is the most important form of capital structure as regards to its role in improving the level of financial performance among the selected SMEs in Kabale Municipality.

The research findings on the relationship between effectiveness in the use of capital structures and financial performance among the selected SMEs in Kabale Municipality has led to the acceptance of the assumptions that effectiveness in the use of debt capital, equity capital and retained earnings among the selected SMEs in Kabale Municipality have positive and significant relationship with financial performance.

5.3.5 Discussion the findings under multiple regression analysis

The regression analysis shows positive effectiveness in the use of debt capital and retained earnings as elements of capital structure and a significant relationship with level of financial performance among the selected SMEs in Kabale Municipality. However, the statistical illustration in the regression analysis suggests that Equity Capital has a weak association with financial performance among the selected SMEs in Kabale Municipality.

This research finding established through multiple regression coefficients reveals that effectiveness in the use of retained earnings is the most important form of capital structure as regards to its role in improving the level of financial performance among the selected SMEs in Kabale Municipality.

However, while Among the three capital structures examined in this study, the study in case of SMEs in Kabale indicates that debt capital has the least boost on financial performance of SMEs and this related to the study by Farna and French (2018) whose study revealed that while using debt capital may add pressure to a firm's ongoing operations as a result of having to meet interest-payment obligations, it helps retain more profits within the firm compared to using equity, which requires the sharing of the firms' profits with equity holders. Thus, using debt capital, the firm needs to pay only the amount of interest out of their profits.

Considering the effect of three constructs under capital structure (debt capital, equity capital and retained earnings) on financial performance individually, it can be said that the capital structure with the highest effect on financial performance among SMEs in Kabale Municipality is retained earnings that has the highest r. and β values at 0.698; this is followed by equity capital whose r. and β values stand at 0.411; and the capital structure with the least influence on financial

performance among the SMEs in Kabale Municipality is the debt capital as its r. and β values stand at 0.391. In this case, it can be said that SMEs need to focus more on the use retained earnings if they need to boost their financial performance more though the rest of the other capital structures can play a vital role in boosting financial performance of the SMEs.

5.3 Conclusions

Following the study findings and specific objectives, the following conclusions were made.

Debt capital and equity capital have a moderate effect on the performance of SMEs in Kabale Municipality whereas retained earnings has the highest effect. The study indicates that effective use of debt capital, equity capital and retained earnings can significantly lead to improvement in the financial performance of SMEs in Kabale Municipality. However, the type of capital structure with the highest influence on financial performance is retained earnings, followed by the equity capital and then, debt capital.

In this case, it's concluded that SMEs need to focus more on the use of retained earnings if they need to boost their financial performance more though the rest of the other capital structures can play a vital role in the general boosting of financial performance.

Based on the conclusions related to the specific objectives, it can be concluded that there is a significant relationship between capital structure and financial performance among SMEs in Kabale Municipality-Uganda.

5.4 Recommendations

Based on the above conclusions, the following recommendations were made: First, the SMEs should be encouraged to use retained earnings capital financing since it was realized that it has the highest positive effect on the financial performance of SME's.

Secondly, the study perceived that SME's do fairly enjoy the services of debt capital maybe because of the strings attached to its interest payment and maybe the conditions of acquiring a loan.

The researcher recommends that the financiers of loans should minimize the requirements for one to qualify for the products since it was observed that debt financing also has a positive effect on the financial performance of SME's.

This study therefore recommends that SMEs should be encouraged to take loans or trade credit to finance their businesses instead of waiting to raise money through savings or maybe sale of property. This would help them to begin their businesses earlier and have greater chances of being able to accumulate Retained earnings.

The use of Equity funding equally has a positive response on the financial performance of SME's. The research recommends that SMEs should use a mix of funding in the order of Equity or Debt Financing at the inception of the business and there after making profits, stick to Retained Capital financing.

5.5 Area for further study

(i) Risk management and financial profitability of SMEs in Uganda

(ii) Operational costs and business sustainability among SMEs in Uganda

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APPENDICES

APPENDIX I: RESEARCH QUESTIONAIRE

I am Kiconco Charity, undertaking a study on Capital Structure and Financial Performance of SME's in Kabale District, Uganda, as a partial requirement for the award of Masters Degree of Business Administration of Uganda Christian University. You have been selected to participate in this study as a respondent. Kindly provide the most appropriate information as indicated in the questionnaire based on your objective experiences. The information provided shall be used for academic purpose and will be kept with utmost confidentiality.

Thank you in advance.

Background Information (Tick as Appropriate)

1. **Age:** 18-25 ☐ 26-30 ☐ 31-35 36☐ 40☐d above ☐

2. **Gender:** Male ☐ Female ☐

3. **Marital status:** Single ☐ Married Se☐ated Divor☐ Widow☐ ☐

4. **Highest Level of education:** Secondary D☐oma Bach☐r's degree Masters ☐ PhD ☐

5. What is your position/ role in business: Owner M☐nager A☐ndant Other? ☐ ☐

6. Which year was the business established? 2019 20☐ 2017 ☐ 2016 ☐ 2015 ☐ Before☐14 ☐

7. How many Employees do you have in your business? 1-50 51-10☐ 101-150 ☐ 151-200 ☐ ☐

Part B: (Business information)

For each of the statements below, please indicate the extent of your agreement or disagreement by placing a tick in the appropriate box.

The response scale is as follows: SCALE	1=Strongly Disagree	2=Disagree	3=Undecided	4=Agree	5=Strongly Agree

8. Type of product (s)/ Services are sold/ given in my Business

		1	2	3	4	5
	Food Processing					
	Accommodation &Food Services					
	Education, Health & Social Services					

9.Capital Structure

The source of funding for my business is

		1	2	3	4	5
	Bank Loan/ Micro finance Loan					
	Profit from the Business (retained earnings)					
	Funds from outside the business eg from friends, gov't, relatives (External equity)					
	Both my own individual funds and Loan financing					
	Any other. Please specify					

10. Why did you prefer the type of business funding you have chosen in question 9 above?

	Strongly agree	Agree	Not Sure	Disagree	Strongly disagree
It's the Cheapest form of funding					

Easy to access					
It was the only funding source available					
Gives a relative higher return on investment					

11. Debt Capital

		1	2	3	4	5
	In the past years to date I have used debt funding in my business					
	Much of our funding in the business is from loan					
	Our business access loans and that has improved our operations					
	I prefer Debt Capital so long as my business achieves relatively high profits					
	We have used loan to expand our business compared to our capital					
	My firm makes regular monthly payments of principal and interest					

12. Equity Capital

		1	**2**	**3**	**4**	**5**
	I have invested my personal funds into my businesses					
	My relatives and friends, have helped me with the capital for my business					

	Using personal funds in the business is much better than adding loans					
	I have continued investing personal funds in the growth of our business					
	We have used our own capital to expand our business					
	Our capital is not adequate to grow the business to where we want.					
	Our capital level has limited our ability to make more business					
	I have sold my personal Asset to finance my business					
	My business does not have any additional financial burden and obligation in form of interest					
	Much of my finance used in the business is capital as opposed to loan					
	The business has high returns because I don't have loans to repay					

11. Retained Earnings

		1	**2**	**3**	**4**	**5**
	We use our profits to acquire more assets in the business					
	We distribute much of our profits to the shareholders					
	We retain most of our profits in the business for expansion					
	We have been able to expand our operations due to reploughing back the profits into the business.					

12. Financial Performance of the SME's

		1	2	3	4	5
	The value of my business's total Assets has increased over the years.					
	There has been an increase in Revenue in my business in the past years					
	There has been an increase in Net profit/ Net income (ie Sales Revenue less all Expenses related to the business) of my business in the last years to date					
	There has been an increase in Net profit Margin (Net Profit/Revenue) of my business in the last years to date					
	There has been an increase in the number of Customers/Clients of my business in the last years to date					
	There has been a gradual increase in the retained earnings over the last years to date.					
	There has been increase in the employees in my business					
	There has been an increase in Cash flow in my business in the last years to date					
	The business is able and can easily pay her short term obligations and current liabilities					

Appendix 2: Interview guide

Interview guide for Business Owners and Attendants on Capital Structure and the performance of SME's

1. What type of product (s)/ Services are sold or given in your Business?
2. What is your position/ role in business?
3. How many Employees do you have in your business?
4. For how long have you had your business or how has your business been in operation?
5. What are the sources of funding in your business?
6. Why do you prefer the type of business funding you have?
7. How has the type of financing you use affected financial performance in your Business in terms of profitability, liquidity and growth?
8. Has the value of your Assets Increased over the years?
9. Have you had an increase in sales Revenue over the years?
10. Have you had an increase in the Net profit of the business over the years?