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Original Article

Impact of debt financing on financial performance of small and medium Enterprises in Kisii Central Sub-County

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Small and Medium Enterprises, Access to financing, Debt financing, Financial Performance, Retained Earnings, Gross Domestic Product Growth Rate.

ABSTRACT

The choice of financial structure and financial management has a greater effect on the financial performance of most firms in the world and in particular Kenya. While most firms try to find a solution to balancing both, financial structure choice and its impact on financial performance remains a greater dilemma to all small and medium enterprises in Kisii County. This was a descriptive survey and questionnaires were used in collecting data from the respondents. Random sampling was used as the general sampling technique with the aid of the Yamane's formula to select 109 SMEs to participate in the study from a target population of 150 SMEs in Kisii Central Sub-County. Statistical package for social sciences (SPSS version 23) was used to analyze both qualitative and quantitative data that was collected during the study. The owner controls the business and enjoys profits whenever it's high and bears the risk alone. It does not entail any charge. This therefore shows equity capital forms higher proportion of financial structure hence has a significant effect on financial performance of SMEs. From the study retaining earnings was well appreciated irrespective of not having a significant effect on financial performance due to challenges of raising it. It stands a chance of being the best source of finance for expansion because it is the cheapest and painless method of raising additional capital. Management of SMEs should ensure that the financial structure of the firm is always at optimum. The firm cannot only survive on equity capital due to its low risk, also cannot wholly depend on debts due to high risk, more so retained earnings is only realized after making profit.

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INTRODUCTION

Osuji & Odita (2012), conducted a studied the impact of financial structure on financial performance of Nigerian firms that were listed in the country's stock exchange. They used a sample of thirty non-financing firms that operated in the NSE between 2004 and 2010. Least square as a method of estimation was used to analyze panel data that was generated during this period. The results showed that a firm's capital data that had a huge debt ratio impacted negatively on the firm's financial performance. The findings indicated a consistency with prior empirical studies on the same.

Nirajini & Priya (2013) studied the impact of financial structure on financial performance of the listed trading companies in Sri Lanka. Using a 7-year data from 11 listed companies listed in Sri Lanka, they concluded that there is a positive relationship between financial structure and financial performance of SMEs. They also stated that financial structure significantly impacts on financial performance of firms and in their long-run, the ability to remain afloat over a period of time. So every firm should make a good financial structure decision in order to earn profit and carry on their businesses successfully.

Birundu (2015) studied the effect of financial structure on the financial performance of small and medium enterprises in Thika Sub-County, using a sample of 40 registered and operating SMEs in Thika County. The findings indicated the relationship between, financial structure, debt and financial performance of the firms. He concluded that although financial structure as a factor affects financial performance minimally, they should be factored any financial decisions that SMEs make.

Matibe (2015) conducted a study on the relationship between financial structure for listed companies in Kenya and their financial performance. The study ran from 1998 to 2002.in this study; he indicated that state owned firms have a higher possibility to borrow unlike individually owned firms, institutions or even foreign investors. He concluded that state owned firms have more access to debt than firms owned individually, and also noted the positive relationship between leverage and a firm's performance.

According to a study conducted by (Hector, Elena, & Gonzalo, 2016), stated that financial structure of some firms in the city of Aguascalientes was consistent with the Agency theory that states the higher the external debt, the lower the financial performance of firms.

Maigua (2014), in his study found that small and Medium Enterprises in Nairobi used debt and equity in their financial structure although debt was predominant. This was because SMEs perceived debt as a cheaper source of funding and that it lowered the taxes paid since it acted as a tax shield. The debt preference over equity therefore implied that interest was the dominant form of cost of capital among the SMEs. He also found out that financial structure had a significant effect on ROA; hence firms with a more liquid stock were highly likely to meet their financial obligations as compared to the

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others. He therefore concluded on the existence of a positive relationship between financial structure and liquidity.

Njagi, Maina, & Kariuki (2017), in their study on equity financing and financial performance of SMEs in Embu town, they found out that equity financing has a positive relationship to the financial performance of the SMEs in the region and therefore most of them do prefer sourcing for capital from friends rather than approach lending institutions. This was because the entrepreneurs prefer sharing risks with less risk averse investors at the same time avoiding any undesirable change in ownership.

Siro(2013), on the effect of financial structure on financial performance of firms listed at the Nairobi Securities Exchange, indicates that the debt ratio had an inverse relationship with return on equity. Therefore, according to his study findings, it does not matter how a firm finances its operations and that the value of a firm is independent of its financial structure.

Mwangi (2016), investigated the effect of financial structure on financial performance of firms listed at the East Africa Securities Exchanges, and stated that financial structure affects the financial performance of firms, though differently based on their capital source. Overall, he found out that there existed a strong effect of financial stricture on both ROA and ROE. He also concluded that a huge proportion of asset financing could imply that short-term debt financing was less costly and therefore available compared to the long term debt financing which is usually associated with high value collateral and at times restrictive covenants hence making it unattractive.

Githire &Muturi (2015), in their study entitled effects of financial structure on financial performance of firms in Kenya, a case study of firms listed in the Nairobi Securities Exchange, concluded on the existence of overwhelming evidence that equity financing has a positive influence on a firm's financial performance. This was because of the direct control exercised by equity holders who ensure that resources allocated to the firms are appropriately utilized in ways that maximize shareholders' interests. Also, they indicated that long-time financing has a positive and significant effect on financial performance. This was evident by competitive advantage when compared to large firms as well as in the development of credit management systems specifically suited for small firms so that they could access long-term financing.

RESEARCH METHODOLOGY

The study adopted a descriptive survey design. This research design suits the research study as it allowed for an in-depth study on how financial structure influences the financial performance of SMEs in Kisii Central Sub-County. The study's target population will be all the SMEs operating within Kisii Central Sub-County. The study employed a census to come up with a list of 150 SMEs that are listed under this geographic location. From this population, 109 SMEs were randomly selected to participate in the study. Random sampling was used to sample 109SMEs in Kisii County that participated in the study. Those who were randomly selected into the sample were interviewed as they were in a position to provide relevant information with regards to financial management of the organizations they represent. Therefore, the study adopted Yamane's formula to obtain a relative sample size of 109 SMEs for the study as follows:

$$n=\frac{N}{1+N(e^2)}$$

Where **n** is the sample size, **N** is the population size and e is the margin of error, whereby (e=0.05).

Therefore:

$$n=\frac{150}{1+150(0.05^2)}$$

n=109

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Primary data was collected through the administration of research questionnaire. After sampling, they were dropped at the various sampled SMEs in Kisii Central Sub-County and collected after two days to allow the respondents to fill them. The questionnaires comprised of both open and closed ended questions. The study questionnaire comprised of three sections: The factors that influence the establishment of the financial structure of the SMEs; how long term-long and short-term financing affects the financial performance of the SMEs. Data that was collected coded before being entered into the computer for data analysis. The data was also cleaned to ensure for completeness of the information obtained. This data was analyzed through the aid of SPSS version 23. Since the study employed both descriptive analysis and inferential statistics, the raw data was presented in form of tables, charts with frequency distributions and percentages, which were vital in making sense of the data.

DATA ANALYSIS AND PRESENTATION

Response Rate

The researcher distributed 109 questionnaires to the sampled respondents but only picked 78 questionnaires, which were fully responded to giving an approximately 72%. 78 respondents (72%) were considered satisfactory for the study and for generalization of the findings. Conversely, 31 respondents (28%) did not return their questionnaires. The high response is attributed to respondents given enough time to fill and questionnaires were collected later.

Financial Advisory Services

The researcher sought to establish whether the respondents ever seek the financial advice when running the business. 59% respondents have never gone for financial advice whereas the rest have done. These results indicate that most of the small and medium enterprises in Kisii County are run by self-financial mind and thus financial move totally relies on the owner decision.

Financial skills

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

Financial management skills

Response	**Frequency**	**Percentage**
Yes	39	50
No	39	50
Total	**78**	**100**

Source: Survey Data, 2022

The number of those who seek financial advice was 39 (50%) and those who do not seek financial advice were 39 (50%). The study shows half of the SMEs are equipped with business management skills and is the reason why a good number tends to excel despite being small in size while others seems to struggle in their business activities

Profit Maximization

The study sought to find out if the SMEs do realize their goal in making profit in their business activities. The results obtained were as shown in table 2.

Profit Maximization

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Response	Frequency	Percentage
Yes	72	92.5
No	6	7.5
Total	**78**	**100**

Source: Survey Data, 2022

Table study findings reveals that, majority (92.5%) of SMEs do make profits in their business activities. This has made them to remain in business. Most of SMEs have no any other source of income and depends on their business for their living. With 72 92.5% being able to make profit, this shows the reason why there has been tremendous growth of SMEs in Kisii County.

Optimal Financial Factors and Financial Performance

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

Sources Finances

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

Source of Finances

Source Of Finance	Frequency	Percentage
Personal Savings	20	26.2
Farming	17	21.4
Employment	30	38.1
Family support	11	14.3
Total	**78**	**100**

Source: Survey Data, 2022

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

Factors determining your firm’s financial structure

Financial structure refers to the mix of debt and equity that a company uses to finance its operations. This composition directly affects the risk and value

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of the associated business. The study sought to establish the following factors determine financial structure of SMEs. A set of six items were used. The findings based on a Likert scale rating, where 1 was strongly not considered (SNC) and 5 was Strongly considered (SC) were summarized in Table 4.5 below.

Factors determining your firm's financial structure

Factor	SC	C	N	NC	SNC	MEAN
Firm Assets	38.7	24.6	30.3	2.9	38.7	2.69
Firm Growth opportunities	53.3	38.3	5.7	0.6	0	2.93
Trading on equity	28.4	32.6	17.9	16.9	0	3.50
Debt and non-debt tax shields	28.4	32.6	17.9	16.9	0	2.31
Financial flexibility	18.2	17.9	21.4	29.4	10.5	2.69
Loan agreements	32.6	18.8	25.3	12.5	8.3	2.98

Source: Survey Data, 2022

From tableabove, the highest scoring item had a mean of 3.50 while the lowest mean score was 2.31. The distribution of the means is normally distributed. Overall, the average score for factors considered important for determining firm's financial structure appears to be average and hence there is need to put more emphasis on how to raise and increase to a level that it commands largest financial structure. According to the Likert scale, score of 5 indicated 37 strongly considered, 4 considered, 3 neutral, 2 not considered and 1 strongly not considered. Hence, results in Table 4 indicate that most of the respondents were in agreement or neutral or disagreed to the selected items on financial structure.

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

CONCLUSION AND RECOMMENDATIONS

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

Conclusion

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

Recommendations

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

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