EFFECT OF FINANCING STRUCTURE ON THE PROFITABILITY OF MICRO AND SMALL ENTERPRISES IN NAKURU CENTRAL BUSINESS DISTRICT

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MAY, 2021

DECLARATION AND RECOMMENDATION

Declaration

I declare that this research report is my original work and has not been presented in any other institution in its present form and manner for the fulfillment of the requirement for the award of a degree or diploma.

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Recommendation

This research project has been submitted for examination with our approval as the university supervisor.

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DEDICATION

Dedication to my parents the late Mr. Joseph Ademba and Mrs. Celine Ogwel: To my lovely wife Lineth Chepngetich, daughter Audrey Achola, brothers, and sister.

ACKNOWLEDGMENTS

I acknowledge the almighty God for the divine strength and inspiration throughout the entire journey of proposal and report writing. Second, I am greatly indebted to Dr. Muiru Monica and Prof. Auka Daniel for the support, guidance, and contribution in ensuring the success of the work by not only critically reading every page in the early draft stages but also helped to nurture this project with enthusiasm and wise advice. My gratitude also goes to all my friends and colleagues for their valuable support whenever I needed it during the study time. Appreciation to my Family member's for their moral and financial support. Finally, I thank the Nakuru MSE ownership who provided the information that was helpful in the study.

ABSTRACT

Financing a business is among the steps towards achieving a firm's objectives. The existing literature on financing structure and profitability of MSEs reveals contradicting results. Some studies established a positive effect of financing structure and profitability, others showed a negative result of financing structure on profitability. This study sought to assess the effect of financing structure on the profitability of micro and small enterprises in Nakuru central business district (CBD). Specific objectives were to: establish the effect of retained earnings on the profitability of micro and small enterprises, determine the effect of personal savings on the profitability of micro and small enterprises, examine the effect of debt capital on profitability of micro and small enterprises, and to establish the joined effect of retained earnings, personal savings and debt capital on profitability of micro and small enterprises. This study adopted descriptive survey research design. Target population was 1,249 MSEs located within the CBD. A sampling formula by Yamane (1967) was applied to arrive at a sample size of 302 MSEs. A systematic random sampling was used in picking of the respondents; every K^{th} MSEs became part of the response group. Structured questionnaire was used for collecting of primary data and frequency tables used for data presentation. Percentages, mean, and standard deviation were used to summarize variables under study while inferential statistics of correlation coefficient and regression were used to test hypothesis and explain the relationship between the variables under study. Z and F tests were used in hypothesis testing at 5% level of significance. Simple regression was applied in establishing the cause-effect of each of the independent variables to the dependent variable. Multiple regression was used to determine the joint cause-effect of the independent variables on the dependent variable. The study revealed that there is a statistically significant relationship between the financing structure and profitability of MSEs. Both retained earnings and personal savings have a significant positive effect on profitability at a 5% level of significance while debt capital has a significant negative effect on profitability at a 5% level of significance. The study concluded that the financing structure significantly affects the profitability of micro and small enterprises in Nakuru central business district. The study recommends that Micro and Small enterprises should continue using retained earnings and personal savings for purposes of increasing profitability before they opt for debt capital. In general, financing structure to be adopted by micro and small enterprises should be that which has a positive influence on profitability.

TABLE OF CONTENTS

DECLARATION AND RECOMMENDATION……...…….ii

COPYRIGHT……..…….....iii

DEDICATION……...…….……...….iv

ACKNOWLEDGMENTS……...……..……..……..…v

ABSTRACT…….....…….....vi

TABLE OF CONTENTS……...……..….....vii

LIST OF TABLES……...……..……...x

LIST OF FIGURES……..……xi

LIST OF ABBREVIATIONS AND ACRONYMS…….....xii

CHAPTER ONE 1

INTRODUCTION.....1

1.1 Background of Study.....1

1.1.1 Financing structure 2

1.1.2 Profitability 3

1.1.3 Financing structure and profitability 3

1.1.4 Micro, Small, and Medium Enterprises in Kenya 4

1.2 Statement of the Problem 6

1.3 Objectives of the Study 7

1.3.1 General Objective.....7

1.3.2 Specific Objectives.....7

1.4 Hypothesis of the study 8

1.5 Significance of the Study.....8

1.6 Scope of the study 8

1.7 Limitations of the Study 9

1.8 Operational Definition of Terms.....9

CHAPTER TWO 11

LITERATURE REVIEW 11

2.1 Introduction.....11

2.2 Theoretical background 11

2.2.1 Theory of capital structure Irrelevance 11
2.2.2 Pecking Order Theory 12
2.2.3 Theory of Free Cash Flow 13
2.3 Review of the literature 14
2.3.1 Micro and small enterprises 15
2.3.2 Financing structure 15
2.3.3 Profitability 18
2.4 Empirical Literature 19
2.4.1 Retained earnings and Profitability 22
2.4.2 Personal savings and profitability 23
2.4.3 Debt Capital and Profitability 24
2.4.4 Moderating effect of business size on financing structure and profitability 25
2.5 The Conceptual Framework 27

CHAPTER THREE 29
RESEARCH METHODOLOGY 29
3.1 Introduction. 29
3.2 Research Design. 29
3.3 Target Population 29
3.4 Sampling and sample size 30
3.4.1 Sample size 30
3.4.2 Sampling procedure 30
3.5 Data Collection Procedures 30
3.6 Validity and reliability test 31
3.7 Data Presentation and Analysis 31
3.8 Operationalization of study variables 33

CHAPTER FOUR 34
RESULTS AND DISCUSSION 34
4.1 Introduction 34
4.2 Results of the Pilot Study 34
4.3 Response Rate 34

4.4 Profile of Respondents 35
4.4.1 Gender of the respondents 35
4.4.2 Form of business ownership 36
4.4.3 Length of enterprise operation 36
4.4.4 Income level of MSEs 37
4.4.5 Number of employees....37
4.5 Descriptive statistics with regards to variables under study....38
4.5.1 Financing structure of MSEs....38
4.5.2 Utilization of the sources of finance in financing the business. 39
4.5.3 Amount of cash flow in the business....39
4.5.4 Profitability of MSEs....41
4.6 Inferential statistics and discussions of the variables under study....42
4.6.1 Correlation Analysis....43
4.6.2 Regression analysis....44
4.7 Summary of results of tested hypotheses 53

CHAPTER FIVE....55
SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS 55
5.1 Introduction....55
5.2 Summary of findings....55
5.3 Conclusion 57
5.4 Recommendations of the study....58
5.5 Suggestion for further studies 58

REFERENCES....59
Appendix A: Questionnaire for the respondent 66
Appendix B: Registered SMEs in Nakuru CBD....69
Appendix C: Research permit letter....75
Appendix D: A copy of publication....76

LIST OF TABLES

Table 3.1: Operationalization of the Variables 33
Table 4.1: Cronbach Alpha for Reliability Assessments 34
Table 4.2: Response Rate 34
Table 4.3: Gender of respondents 35
Table 4.4: Response to business ownership 36
Table 4.5: Length of enterprise operation 36
Table 4.6: Monthly income level 37
Table 4.7: Number of employees 38
Table 4.8: Sources of Financing in Business 38
Table 4.9: Utilization of the sources of financing. 39
Table 4.10: Amount of cash flow in the business 40
Table 4.11: Profitability 42
Table 4.12: Correlation matrix 43
Table 4.13: Effect of retained earnings on the profitability of MSEs. 45
Table 4.14: Effect of personal savings on the profitability of MSEs 47
Table 4.15: Effect of debt capital on profitability of MSEs 49
Table 4.16: Joint Effect of Retained earnings, personal savings, and Debt capital on Profitability. 51
Table 4.17: Summary of results of test of hypotheses 54

LIST OF FIGURES

Figure 2.1: Conceptual Framework 27

LIST OF ABBREVIATIONS AND ACRONYMS

ANOVA:	Analysis of Variance
CBD:	Central business district
FCF:	Free cash Flow
GDP:	Gross Domestic Product
GoK:	Government of Kenya
GP:	Gross profit
KIPPRA:	Kenya Institute of Public Policy Analysis
MM:	Modigliani and Miller
MSEs:	Micro and small enterprises
NP:	Net profit
NSE:	Nairobi Securities Exchange
ROA:	Return on Asset
ROE:	Return on Equity
SMEs:	Small and medium-sized enterprises
SPSS:	Statistical package for social sciences
YEDF:	Youth enterprise development funds

CHAPTER ONE
INTRODUCTION

1.1 Background of Study

In Kenya, Micro Enterprise is a business that has between one to ten employees with an income of Kshs 1million to 5million. Small businesses range between eleven to fifty staffs and income of between Kshs 5million to 50million while Medium businesses have between fifty-one and one hundred workers with revenue of between Kshs 51million -1billion. These businesses split around all segments of employment, (Sessional paper No 2 of Government of Kenya, 2005).

Micro and small businesses (MSEs) have a significant role in the economy. They are major sources of economic upturn in developed and developing countries (Osinde, 2011). In the United State, the MSE segment provides 67% employment and 61% manufacturing output, correspondingly. In Korea, MSEs constitute 99.9% of the enterprises and employs above 88.1% of the workforce. Equally, in Kenya, they contribute around 80% of employment and add nearly 40% to GDP (Osinde, 2011). The Kenyan government is aware of the crucial role the private sector plays in its economic development. This has made it to initiate finance schemes such as youth and women fund and the Uwezo fund with a view of financing the SMEs (KIPPRA, 2007).

The Financing structure debate has for a long time, discussed issues on the financing structure put forth by Modigliani Miller in 1958. Modigliani Miller's first preposition model argued that financing structure is irrelevant in determining the value of the firm and its prospect. Under this proposition, Modigliani Miller assumed that the investors have homogenous expectations, and there exist no transaction cost and taxes. This model assumed that investors operate in the perfect capital market. Modigliani Miller 1961 in the second preposition argued further that the value of the firm can be increased by changing the financing structure which is due to the

presence of tax shield benefit on debt financing. Modigliani Miller disregarded the existence of the perfect capital market in which the businesses operate in.

1.1.1 Financing structure

Investopedia defines financing structure as the mix of debt and equity that an organization uses to finance its operations such as short-term borrowings, long-term debt, and owners' equity. It differs from financing structure in that financing structure accounts for long-term debt and equity only. The financing structure is also considered as a framework for various types of financing employed by a firm to acquire and support resources necessary for its operations. It comprises of equity capital, long-term loans, loan capital, short-term loans such as overdraft, and short-term liabilities such as trade credit. Pandey (2009) postulates, financing structure is how firms engage a single form of financing in place of the other concerning the dichotomous sources of debt and equity. It describes how firms finance their overall operations and growth by employing various sources of funds. Firms can either use debt or equity or both to finance their assets. Generally, firms can choose the aforesaid alternative financing structure (Abor, 2005). However, the best choice of financing structure is a mix of debt and equity (Shubita & Alsawalhah, 2012). It is averred that if interest is not tax-deductible, owners of firms would be indifferent regarding the options of equity and debt. On the other hand, if interest is tax-deductible, owners would maximize the value of their firms by employing absolute (100%) debt financing (Shubita & Alsawalhah, 2012). According to Brigham and Houston (2011), the financing structure is highly relevant for the company as it relates and affects the risks borne by the shareholders as well as the rate of return or the expected profit rate. The creation of financing structure in an organization will influence the governance structure of a business organization which in turn, has a direct effect on strategic decisions made by management (Mwangi et al., 2014)

The management team of a firm or business faces numerous financing structure choices that they consider adopting at their discretion. Funds used for business operations may be generated from internal or external. When raising funds externally, businesses choose between equity and debt.

In most cases, the financing decision-making process of businesses is centered on determining the optimal financing structure of the business (Narayanan, 1988).

1.1.2 Profitability

Businesses have different objectives that are largely observed in their strategies like, growth and profitability. Profitability is the measure of earnings in the business or steadiness of cash inflows in a business over a while. It can be determined by making a comparison with similar firms across the same business industry in aggregate to enable business in deciding on how it may improve on the predominant situation. Profitability is subject to several elements including the size of the business, exports from the business, dependence on debt, age, growth in non-current assets, and sales increase. Different methods are used in measuring the profitability of a firm such as return on assets (ROA) and return on equity (ROE)). Return on assets is a measure of how well a business uses its assets to create profit. Return on equity is a measure of how a business will receive profit from the capital invested in it by the owners. Both Return on Assets and Return on equity provide a long term outcome of business performance (Vijayakumar & Devi, 2011).

1.1.3 Financing structure and profitability

Studies have been carried out on the relationship that exists between financing structure and profitability. Studies such as the one done by Thuranira (2014) studying about retained earnings' effect on the stock return of companies listed at the Nairobi Securities Exchange. The result of this study concluded that retained earnings were not relevant in determining the value of Returns on stock earned. Salawu and Obafemi (2009) also examined the effect of financing structure on the profitability of Nigerian firms listed at the stock exchange. The findings from the study indicated that the financing structure effect is insignificant on the profitability, but a positive relationship between profitability and short-term debt existed. Equity in financing structure has also a positive correlation with profitability. The result further provided negativity in the relationship between the ratio of total debt to total assets and profitability. Ramadhan and

Trenggana (2014) also examined the effect of debt on profitability in telecommunication in Indonesia. The study aimed at knowing how short-term debt and long-term debt influence profitability which was measured using the return on equity. The finding of the study showed no effect of short-term debt on return on equity; no effect of long-term debt on return on equity; and in totality debt does not affect the return on equity. The study concluded that other factors other than debt also affect profitability. The study recommended companies to take good financial management strategies so that the business can generate huge profits to cover the debt.

Nyanamba et al. (2013) examined factors determining the structure of financing among Micro-Enterprises in Kisii town, Kisii County. It was concluded that factors affecting the structure of capital in micro-enterprises included capital market access, size, profitability, the attitude of creditors concerning the business, structure of assets, lending interest rates, age of the business, and attitude of the management toward risk. Wagana (2014) also examined the relation of financing structure on the financial performance of the top a hundred small and medium enterprises in Nairobi County. The outcome confirmed a negative relation of financing structure on the financial performance of SMEs.

1.1.4 Micro, Small, and Medium Enterprises in Kenya

The importance of the Micro and Small enterprises sector to the Kenyan economy has been recognized widely. The MSE sector is crucial to the government's effort in reducing poverty as it employs nearly 6.8 million Kenyan and of the new jobs created, 89% were in the small sector firm. The Kenyan government is aware of the crucial role the private sector plays in its economic development. This has made it to initiate a finance scheme such as youth and women fund with a view of finance the SMEs (KIPPRA, 2007). MSEs in Kenya serve as live blood to the poor; create employment opportunities, generate income, and contribute to economic growth (Mukoma & Masini, 2015). According to Katua (2014) MSEs have been accepted as the core engine of economic growth and poverty eradication in the world. According to the Economic Survey report (2016), there were 1.56 Million licensed MSEs and 5.85 Million

unlicensed MSEs, where wholesale and retail trade accounted for 57.1 % which was more than half of the licensed businesses in that year.

In recent years the performance of MSEs has continued to decline in Kenya. Virtually, a majority of those that had been contributing up to 40% of the total employment in Kenya have collapsed. Other MSEs were auctioned while some were merged or acquired signifying questionable financial performance due to lack of proper management of debt acquired (Sessional paper No 2 of GoK, 2009). MSEs continue to face challenges such as overlap and inconsistencies in legal and sectoral policies, lack of clear boundaries in the institutional mandate, lack of suitable legal framework, outdated council by-laws, unavailability of land and worksites, exclusion of local authorities in policy development, lack of access to credit, lack of central coordination mechanism, lack of devolved coordination and implementation mechanism (Sessional paper No 2 of GoK, 2009). MSEs' lack of access to finance is a major constraint to their growth in Kenya (Atieno, 2009). The problem of choosing the best source of finance is the major challenge. Most SMEs rely on borrowing from friends and relatives or self-financing (Kamau, 2011). Banks are not providing enough support to MSEs for one reason or the other and this affects their faster growth (Chimaleni *et al*., 2015). Personal income, Bank loans, Venture capital, Leasing, Sale of Shares, Government loans, and Microfinance loans are used to finance most MSEs in Kenya, but commercial banks find it difficult to provide funds to MSEs as they consider them as high-risk clients (Muriithi, 2014).

Therefore, this study begins by looking at the financing structure theories and their relevance to the profitability of firms. It also looks at the relation of the components of financing structure including retained earnings, personal savings, debt capital, and a combination of all the three components of the financing structure mentioned on profitability. Profitability was measured through the net profit margin.

1.2 Statement of the Problem

In the recent years, the contribution of Micro and Small Enterprises towards economic growth and development has been recognized by the governments of different countries all over the globe. In Kenya for example, the government has gone ahead to set aside funds for boosting these enterprises through the establishment of initiatives such as the youth enterprise development funds (YEDF), women enterprise fund, and the Uwezo fund (Government of Kenya, Status report, 2008). Financing structure decisions are significant in maximization of returns for business enterprises and as a result, determination of an optimal financing structure becomes an important role in financial management (Pandey, 2009).

Existing studies on business enterprises has more focus to financing structure and performance of small and medium enterprises with emphasis on those listed at the stock exchange. Adenkule (2012) did a study on the relationship between available forms of finance and the performance of intermediate cocoa processing firms, and found that there was a strong correlation between available forms of finance and financial performance. The Study recommended for policymakers to route their intervention fund to the agricultural sector. Yegon et al. (2014) did study on the effects of capital on Firm' Profitability in the Banking Sector and found a significant positive relationship between short-term debt and profitability and a statistically significant negative relationship between long-term debt and profitability. They recommended that a business should consider using a financing structure having some debt, but not in totality. The Contribution of Githire and Muturi (2015) in a study on the effects of the structure of capital on the performance of firms in Kenya established that equity and long-term debt portray a positive and major effect on financial performance, whereas short term debt has a negative and major effect on financial performance. It recommended that firms should increase financing through equity for good financial performance. Rafiq (2012) did a study on the causal relationship between financing decisions and the financial performance of SMEs and found a positive relationship between financing decisions and performance. The Study recommended that SMEs should consider risks and benefits when sourcing finance for better financial

performance. Touseef (2014) did a study about the effect of financing structure on the profitability of the cement sector. It found that profitability is related to financing structure in a significant way but on the other hand, profitability had an inverse relation with the amount of liability in a company's financing structure this meant that the more a firm incurred debt, the more the earnings were hurt. The study recommended that the cement sector should rely more on equity instead of debt for good financial performance.

From the foregoing literature review, it is observed that the previous scholars did not look much into micro and small enterprises. It is against this reason that this study aimed at adding more knowledge on the effect of financing structure on the profitability of Micro and Small Enterprises by looking at MSEs in Nakuru Central Business District. Using Descriptive statistics and inferential statistics, in-depth insight into the topic at hand was examined. Data was contextualized with a review of recent literature on financing structure and profitability in Nakuru central business district.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of the study was to assess the effects of financing structure on the profitability of micro and small enterprises.

1.3.2 Specific Objectives

i. To establish the effects of retained earnings on the profitability of MSEs.
ii. To determine the effects of personal savings on the profitability of MSEs.
iii. To evaluate the effects of debt capital on profitability of MSEs.
iv. To establish the joined effect of retained earnings, personal savings, and debt capital on profitability MSEs.

1.4 Hypothesis of the study

$H_0$1: Retained earnings have no significant effect on the profitability of MSEs.

$H_0$2: Personal savings have no significant effect on the profitability of MSEs

$H_0$3: Debt capital has no significant effect on the profitability of MSEs.

$H_0$4: Joint retained earnings, personal savings, and debt capital have no significant effect on the profitability of MSEs.

1.5 Significance of the Study

Micro, Small, and medium businesses are among the major sources of economic livelihoods and are responsible for about 80% of employment contributing about 40% of the GDP (Osinde, 2011). Nevertheless, the financing structure decisions of MSEs have affected their objective by influencing the profitability of these enterprises. For these reasons, therefore this study will be of significance in various ways as follows:

To the management and ownership of Micro and Small enterprises, they will gain knowledge of the most appropriate financing structure to use for them to gain more on profitability. It will help them in choosing the best financing mix for the businesses. The study will also be significant to the government in establishing the best way of boosting MSEs' financial needs to offset them with the burden of financing costs which is a determinant of financing structuring. This is because of the role played by these MSEs play in the economy. The study will also be significant to future scholars and researchers who may use this study as a basis in carrying out further research in the same line and gain knowledge on the impact of financing cost and profitability in other areas of interest.

1.6 Scope of the study

This study was carried out in Nakuru central business district (CBD). The respondents were owners of micro and small enterprises. The enterprises targeted included Curio shops, Boutique, saloons, electrical, electronic shops, hardware shops, bookshops, restaurants, and spare shops.

The researcher selected Nakuru town CBD for easy access, as he resides there and therefore there was a significant reduction on the research budget. It is also considered among the fastest-growing towns in Kenya economically. Data covered five-year period from 2011 to 2017 and those MSEs that keep financial records formed the final data for analysis.

1.7 Limitations of the Study

The study might not have covered enough in terms of scope because it was carried out on MSEs in Nakuru CBD. It may not be the actual representation from other towns within the country as views of business from other towns and regions may vary. The respondents may not have been honest when answering the questionnaire as some were reluctant in providing information as they deemed them sensitive. To allay against this, the researcher explained to the respondents the importance of the study and assured them that the data collected was to be used solely for academic purposes. Additionally, the researcher used a sample size that was proportionate to the population, validity, and reliability of the research instrument done through a pilot study.

1.8 Operational Definition of Terms

Debt capital: It is a liability whereby a firm borrows a certain amount of money to be paid back with interest.

Debt Equity Ratio: It refers to the proportion of how much an enterprise's capital is from external financing and how much is from an internal source.

Financing structure: It describes the various sources of financing (financing mix) used in financing micro and small enterprises.

Internal equity capital: Amount of finance obtained from either personal savings or the profit within the business

Micro and Small enterprise: A business of between one and fifty employees and having an income of between Kshs 1million to 50million

Net profit Margin: The proportion of profit after taxation to total sales made in the same period within the enterprise.

Personal savings:	Amount of money set aside from income received for a period for purposes of investment capital in the business.
Savings ratio:	It is the proportion of total savings introduced in the business to the total capital used in the enterprise.
Profitability:	The returns in the business or the continuous flow of cash in the enterprise.
Retained earnings:	Funds set aside from undistributed profits by the owner of the enterprise for use as additional capital for the business.
Retained profit ratio:	It is the proportion of total profit set aside and used as additional capital to the total capital employed in the enterprise.
Return on Asset:	It refers to the proportion of profit after taxation to total assets used in the enterprise.
Return on Equity:	It is the profit that the enterprise remains with after taxation. It measures the earnings that a firm is making on the funds invested in the financing structure.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction.

The chapter entails a review of information about the topic under study. A literature review is relevant as it enables the researcher to examine and familiarize with the existing knowledge regarding the study and to form an entry point and framework within which to interpret and analyze the research findings. Therefore, this chapter gives an analysis of the critically reviewed literature on the topic under study, through theoretical review, empirical review and a conceptual framework.

2.2 Theoretical background

Theories are used to provide the basis for establishing the hypotheses to be tested in the study (Mugenda & Mugenda, 2003). In this study, theories that were used to guide the study included the theory of capital structure irrelevance, pecking order theory, and the theory of free cash flow.

2.2.1 Theory of capital structure Irrelevance

The capital structure irrelevance hypothesis was proposed by Modigliani and Miller (1958). It forms the basis for modern financing structure thoughts and explains that financing structure is crucial in examining the worthiness of a business. It theorizes that the market value of a firm is determined by its earning power and by the risk of its underlying assets and that the value it has is not dependent on the way it chooses to finance its investments. It adds that a tax shield is witnessed in using debt and firms may decide on an all-debt structure. The theory stipulates that capital decisions by businesses are unrelated to the value of the business. This philosophy has four assumptions; including the worthiness of an entity is equal irrespective of whether it funds its activities using debt or equity, the percentage return on equity increases proportionately according to debt ratio. Inferring that as more debt compared to equity will be in the structure more will be the equity's return rate. Circulation of dividends will not alter the worthiness of a

firm in the market but changes the mixture of equity and debt in the structure and in adopting an investment, a business must assume a return rate that is nonetheless the same as the cost of capital.

Brigham and Ehrhartdt (2004) have opposed the Miller-Modigliani (MM) model by saying that bankruptcy costs occur and will escalate in the event equity is traded off in the place of debt. Robb and Robinson (2014) content with Brigham by stating that outcomes through leverage are important, and using debt improves the worthiness of a business in the market. The theory is relevant in this study in that it forms the basis of the hypothesis formulated about financing structure effect on the profitability of SMEs. By looking at the assumptions made, the result of the study will confirm whether the financing structure is influential in examining the profitability of the enterprise or it is irrelevant. It is the basis of confirming the hypothesis under study.

2.2.2 Pecking Order Theory

Donaldson (1961) came up with the Pecking order theory which was then modified by Myers and Majluf (1984) that proposed an alternative to explain why firms choose a certain financing structure. This theory is termed as the pecking order theory which is a preference order theory. It explains that there is an order of preference normally followed by management in funding a business. The theory explains the reason some organizations finance their activities the way they do is because of the opinion that most lucrative businesses in an industry have the smallest quantity of leverage. The theory clarifies why a bigger margin of external funding originates from debt and the reason majority of firms who are profitable borrow less. The sequence considered in financing is that businesses have a preference for financing internally and if external financing is required; businesses will provide security that is safe first. Beginning with debt, followed by a mixture of convertible bonds then closing with equity as a final option. It provides that businesses that are rated high in profitability prefer funding internally and in case external funds are needed; the organization will borrow, instead of issuing equity. This theory

stipulates that businesses sell equity shares when it has been overvalued in the market, assuming management's act is in the best interest of present shareholders (Shubita & Alsawalhah, 2012).

According to this theory, firms have three main sources to fund the financial needs which are internal funds, debt, and new equity. The theory claims that most firms prefer to use firstly internal finances such as excess liquid assets or retained earnings. If it is necessary to turn to external finance firms use debt with little or no risk, which usually corresponds to short- term debt, and in the last place, firms will select external equity (Njagi *et al*., 2017). Njeru (2013) puts it that finances contributed internally are preferred by SMEs since they are usually very cheap and easier to arrange for by giving a short notification. The moment internal financing is not sufficient to fund investment projects, external funding may be sourced. If they do, to minimize costs the managers have to choose debt before using equity. The theory was useful for this study since it became the basis upon which hypothesis was tested.

2.2.3 Theory of Free Cash Flow

Free cash flow theory (FCF) was introduced by Jensen (1986) whose focus was on how to balance cash flow and the cost of free cash flow. He defined FCF as net cash flows after deducting the needs of positive NPV projects. FCF theory states that when a company has generated an excessive surplus of FCF and there are not profitable investment opportunities available, management tends to abuse the FCF in hands so as to result in increased agency costs, insufficient resource allocation, and wrongful investment. Jensen reasoned that too much FCF would result in internal insufficiency and in the waste of corporate resources, thereby leading to agency costs as a drain to stockholder's wealth. He added that even if cash flow has a positive effect on corporate performance, free cash flow may have an effect that is negative on corporate performance.

Brush et al. (2000) found that sales growth was most beneficial to companies with lack of cash flows, but not necessarily to firms with sufficient FCF and thus supported the FCF hypothesis.

The study asserted that weak corporate governance caused the inefficiency in the allocation of free cash flows since the corporate board of directors was directed at the policies in favor of management's interest at the expense of stockholder's wealth. Harford (1999) finds evidence in support of the free cash flow theory by observing that cash-rich acquirers have share-market returns that are negative at the takeover announcement period and the combined firms have poor operating performance. Schwetzler and Reimund (2004) who examined the cash holdings of German firms likewise established evidence consistent with the free cash flow theory. They observed that compared to a sample of firms matched on industry and firm size, firms with persistent excess corporate cash holdings over a three-year period have significantly lower operating performance, proxied by the operating cash flow. Chung et al. (2005) also observed that excessive FCF might have a negative impact on corporate profitability and stock valuation and thus suggested the control hypothesis of institutional investors.

In contrast, the study by Mikkelson and Partch (2002) establishes evidence against the free cash flow theory. Specifically, they observed that the operating performance of high cash firms is about 1.5 times higher than the performance of benchmark firms. They define high cash firms as firms that hold more than 25% of their total assets in cash and cash equivalents at the end of each fiscal year and whose cash ratios do not fall by more than one-third for the entire period. Gregory (2005) examined how FCF influences merger performance based on UK data and found that mergers with a higher level of FCF performed better than those with lower FCF levels as evidence invalidating the FCF hypothesis. The theory was of relevance for this study because enterprises generate cash flows that will determine performance.

2.3 Review of the literature

This section provided a discussion on the micro and small enterprises, financing structure as well as profitability which are the key terms of consideration in the study.

2.3.1 Micro and small enterprises

Micro Enterprise is considered a business of between one and ten workforce with an income of between Kshs 1million to 5million. Small businesses range between eleven to fifty staffs and income of between Kshs 5million to 50million while Medium businesses have between fifty-one and one hundred workers with revenue of between Kshs 51million -1billion, (Government of Kenya, 2005). The financing structure looks at how firms/businesses finance themselves through debt capital and equity capital. Describing how equity and debt are composed to enable a business fund assets. Financing structure in business is significant as it shows the firms potential to meet the shareholder's needs. A Financial manager in a firm has to always endeavor to come up with a financing structure benefiting both the equity holders and other groups including personnel, clienteles, creditors, and the public at large (Pandey, 2009). Chen and Hammes (2004) postulates that profitability states the efficiency of administrators in utilizing the total assets for the generation of returns. Stockholders will be interested in the profitability of an enterprise for the reason that it can forecast the impending returns in the enterprise. External investors will, consider profitability as part of their scrutiny of the organization to decide on investing.

2.3.2 Financing structure

In sourcing for finances, investors are concerned with the cost that is likely to be incurred for each capital acquired. The sources of finance are majorly categorized into debt financing and equity financing with their respective cost being interest charges and dividend charges plus other explicit costs (Pandey, 2008). A survey in Kenya for the top one hundred small and medium enterprises stated that the majority of these enterprises depend deeply on personal savings or loans from financial institutions for capital increase (Mwarari & Ngugi, 2013).

2.3.2.1 Equity Financing

Equity financing comprises of retained earnings, personal savings, contribution from board members, contribution from partners and friends, deferred income, and cash flows of the business (Kongmanila & Kimbara, 2007). Retained earnings as a source of finance to SMEs

arises out of undistributed profits, which is a cost-free source of finance to the enterprise as its cost is regarded as an opportunity cost that is equal to the dividends paid out (Moyer et al., 2005).

In equity financing business owners invest their funds into their businesses. It is an important source of finance and has a positive relationship with the performance of the business. Firms that use equity finance can make their performance better since there is direct control and because equity holders are residual claimant, they have to ensure that resources are allocated efficiently. In this regard, Equity financing will ensure that SMEs have full control (Githire & Muturi, 2015).

According to Njagi *et al*. (2017) equity financing is comprised of retained earnings, personal savings, contribution from friends, deferred income, contribution from partners and cash flow of the business. They further state that SMEs using Equity financing are seen to have a positive relationship with the performance because the risk involved is minimal since no fixed monthly loan repayments are made. Moreover, if SMEs have an 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. Moreover, Bell and Vos, (2009) notes that when SMEs have an unconstrained choice between external financing and internal financing, they will choose not to use external financing because of a desire to retain control and independence. They further conceded that the owners of SMEs may show a strong preference for the funding options, which have minimal or no intrusion into the business that is retained earnings and personal savings.

According to Myers (1984) equity is of two types, those within the organization (internal) and those from outside the organization (external). Internal equity forms a portion of the business's income to be distributed. It, therefore, represents a reinvestment into the business. External equity, on the other hand, denotes capital obtained by the issuance of fresh shares to the public,

and is in form of preference share capital and ordinary share capital. Sibilkov (2009) affirms that equity permits the business to attain capital without incurring debt, endorsing that capital acquired using equity doesn't call for repayment at a specific time. After buying ownership in the business, investors expect to get back returns made from profits in the future. Stockholders have dispensation to gain in the profits of the business as part of dividends or future gains of capital.

For Graham and Harvey (2001) a business will introduce external equity where internal equity is limited to meet the expected opportunity of investing. Narayanan (1988) adds to the argument by explaining that the moment a business obtains excess capital through issuing of equity, it is already an indicator of not having adequate reserves or cash flows, which can lead to the undervaluing of the business's shares by the fact that when financing businesses using external equity, the share prices occasionally drop.

2.3.2.2 Debt Financing

According to Watkins (2002), businesses tend to use debt as a source of capital because it provides room for increasing the average return on equity funds. The effect is felt as long as the investment rate of return is over and above the return rate on the debt. Watkins demonstrated how shareholder return is affected by leverage by relating the rate of return of equity to that of debt through an equation of Req = Ra + L (Ra - Rd). According to Watkins, the association above provides greater influence when choosing to finance an asset because when debt's return rate surpasses the asset's return, equity's return will be smaller than the asset's return. This will imply that investors will not benefit from the asset because equity return has been minimized by the funding of the excess of return to debt in addition to gains from the asset, and when leverage ratio is high, it increases the negative effect on equity's return.

Ramachandran (2011) studied how financing structure affects profitability by looking at Indian industries. Result showed presence of a strong relationship between financing structure variables and profitability. The implication is this result is that financing structure in an enterprise is

important in determination of profitability such that an upsurge in debt financing will have a habit of reducing the earnings in a business. Huang & Vu Thi (2003), in highlighting their distinctiveness, businesses should combine different sources of financing. The use of debt alone as a source of capital is dangerous because of the likelihood of being bankrupt. In the season when interest rates are high, returns on investment will be cleared by paying high interest. At the same time, using equity alone in sourcing for finance is risky because an enterprise will finance new investments using cash.

A report from the World Bank informs that in Kenya, there is more use of internal financing standing at 48.95%. Equity is the least used at only 0.58% while there is no use of credit cards and leasing. Other sources are rated as follows; bank (both long-term loan overdrafts) 37.67% leasing 1.4%, development funds/grants 1.63%, trade credit 3.95%, credit cards 0.00%, family and friends 0.00%, other financing 5.81%. These are compared with the other two different countries. I.e. the US and the UK. (World Bank climate survey, 2003).

2.3.3 Profitability

The determinants of profitability are elements such as the size of the business, business exports, use of debt in the business, age of the business, growth in fixed assets, and increase in sales. Different methods have been used in the profitability measurement of firm examples are asset returns (ROA), equity returns (ROE), and net profit margin. Assets return measures how well an organization will utilize its assets in obtaining profit. Equity return measures the ability of businesses to get profit from what shareholders invested as cash while the net profit margin is the percentage of revenue left after all expenses deducted from sales, it reveals the amount of profit that an enterprise can extract from its total sales. Both of these measures will provide the performance of the business in the long term (Vijayakumar & Devi, 2011).

For Berger and Bonaccorsi (2006), financial performance of a business can be analyzed by observing the financial status, both at the end and the start of an accounting period. It is

determined through ratios from financial statements or using the information on prices of stock. The ratio will indicate whether the business is meeting the objective of the shareholders through wealth maximization. Net profit margin, a measure is expected to adjust in value if the earnings of the enterprise and sales are adjusted too. It is related to retained earnings and personal savings since the yield from these sources of capital is settled using profits received in the enterprise. The most commonly used performance proxies are the GP margin, NP margin, and operating ratios (Munyuny, 2013).

2.4 Empirical Literature

Studies have taken place concerning financing structure and profitability both at the local and global level. An optimal financing structure is that in which its weighted average cost of capital is at a minimum, leading to the maximization of the business's worthiness. While some scholars observed positive effects of financing structure and profitability, others observed a negative effect, while still others observed a mix of negative and positive results.

Heshmati (2001) in his study on dynamics of the financing structure of micro and small firms in Sweden was able to establish that listed companies have easier access to the equity market compared to smaller companies. This is because of a low fixed cost thus indicating a negative relationship between firm size and debt levels. Rafiq (2012) in a study on the causal relationship between financing decisions and the financial performance of SMEs, the study noted that there is a positive relationship between financing decisions and performance. It was recommended that SMEs in should consider risks and benefits when sourcing finance. Kiprono (2010) looked at the relationship between the sources of funds and profitability of SMEs in Nakuru. Using descriptive study design, result portrayed an existence a relationship between the source of finance and profitability.

Touseef (2014) examined the effect of financing structure on the profitability of the cement sector in Pakistan. The variables used in measuring financing structure were debt to equity ratio,

debt ratio, interest coverage ratio, short term debt to asset, and long term debt to assets while profitability was measured using a return on equity. Using the Fixed and Random effect model as a tool of analysis, it was observed that profitability is related to financing structure in a significant way but on the other hand, profitability had an inverse relation with the amount of liability in a company's financing structure. Meaning that the more a firm incurs debt, the more the earnings are hurt. It was concluded that the cement sector uses a lot of short term debt because of fewer interest expenses but they suffer losses because of using extreme long term debt. The recommendation from the study is that the cement sector should rely more on equity instead of debt.

Yegon et al. (2014) examined financing structure effects on a firm's profitability in consideration of Kenya's banking sector. Using regression model it was observed that a significant positive relationship between short term debt and profitability exists. On the other hand, long- term debt has a significant negative relationship with profitability. It was recommended that a business should consider using a financing structure that allows them to have lower debt amounts. A debt to equity ratio for the business that eventually will reduce the cost of capital, hence reducing the chances of bankruptcy.

Mwangi et al. (2014) looking at the relationship between financing structure and performance for non-financial companies listed in the Nairobi securities exchange in which performance was measured using both the return on asset and return on equity while Financial leverage, total current assets to total assets ratio and total current liabilities to total assets ratio were used as measures of the financing structure. Using explanatory non-experimental approach research design, results showed a significant negative association with performance. It therefore recommended a reduction on over-dependence on long term debt in financing.

Githire and Muturi (2015) looking at the effect that structure of finance had on the performance of firms in Kenya financially using data of firms listed in the Nairobi securities exchange.

Financing structure measures included equity, long-term debt plus short-term debt while the measure of financial performance was the return on asset. Through multiple regression tools of analysis, finding showed positive, significant relation of both long-term debt and equity on financial performance. A negative, significant effect was observed for short term debt on financial performance. It recommended a need to increase financing through equity.

Ronoh (2015) while assessing financing structure effect on the financial performance of listed commercial banks in Kenya, considering returns on assets and return on equity ratios to measure financial performance while financing structure measures were deposits, debts, retained earnings, and equity. Using descriptive design, finding showed a negative but significant relationship between deposits, debt, and equity to financial performance. On the contrary, retained earnings showed a positive but not so significant relationship to financial performance. Conclusion from the study was that financing structure is of significance and it negatively affects financial performance. A further research in other factors that affect the performance of industries was recommended.

In a similar study, Wagana (2014) examined the relation of financing structure on financial performance of the top a hundred small and medium enterprises in Nairobi County. Short-term debt to total assets ratio, long-term debt to total assets ratio, total debt to total assets ratio, and total debt to total equity ratio were considered as the measures of structure of financing. performance was measured using equity returns, asset returns, earning per share, and market value to book value of equity together with the Tobin Q ratio. Using cross-sectional and descriptive survey designs, outcome confirmed a negative relation of financing structure on the financial performance of SMEs. The study recommended firms to avoid high leverage because it might lead to bankruptcy.

2.4.1 Retained earnings and Profitability

A study by Khan (2012) on dividend effect to prices of stock in Pakistan among chemical and pharmaceutical industries, result showed that the ratio of retention plus return on equity both have a positive relationship with the financial outcome which is also significant. According to Khan, the reason why earnings are retained is that the more the firm retains the earnings, the more it increases the chances of growth.

Thuranira (2014) studied about retained earnings effect on the stock return of companies listed at the Nairobi Securities Exchange. Using descriptive design, Results exhibited no significant relationship in returns on stock and retained earnings through a simple linear regression model. Besides, the results also revealed that a multiple linear regression model was significant. It was concluded that retained earnings were not relevant in determining the value of returns on stock earned.

Retained earnings (Njeru et al., 2012) make up an important source of financing for established SMEs in developing economies. Wang (2013) contends that Chinese SMEs in Taizhou depended on retained earnings as a source of financing to a level that Micro-financing lost prominence among its customers. On average doubling, the application of retained earnings led to a decline in the usage of micro-financing by a staggering figure of 22.8%. Abouzeedan (2003) makes it clear on this trend by asserting that retained earnings are one of the cheapest financing sources that SMEs can access and utilize. Timoshenko (2012) argues that once firms survived the first phase of the growth cycle, they had a tendency of delinking funding efforts from personal savings and instead depended on retained earnings to finance business expansion programs.

Egbuna and Agali (2013) highlight the significance of retained earnings in financing SMEs' start-up and operational activities. In Nigeria 21.4% of respondents agreed that they sourced their finances from retained earnings; this is in line with prior studies that highlighted this fact.

Chepkemoi (2013) asserts that SMEs in Kenya heavily depended on retained earnings to finance their investments in their early stages of inception. This was because they were still young and had not established a sufficient network to qualify for external financing. The popularity of retained earnings as a form of financing among SMEs, calls for a critical examination of their effect on the financial performance of these enterprises in Lurambi Sub-County.

Muganda et al. (2016) concur that retained earnings financing affects the financial performance of small and medium enterprises significantly. This was in their study on the effect of business financing on the performance of small and medium enterprises in Lurambi sub-county, Kakamega where they used descriptive and inferential statistics. Njagi, (2017) in a study about equity financing and financial performance of SMEs in Embu town, Kenya, using a descriptive survey research design and using both Pearson's correlation and multiple regressions. The result showed that SMEs had a greater preference for contribution from friends and plowing back profit as a source of equity finance and that equity finance had a positive relationship with the financial performance of the SMEs.

2.4.2 Personal savings and profitability

Wardhana (2012) in establishing the relationship between personal savings and profitability of nonfinancial SMEs in Nigeria using a Two-Stage Least Squares model for analysis, result showed that the savings of an enterprise have a significant influence on the profitability of SMEs. Okumu (2013) examined the relationship between business savings and business performance of listed firms in NSE. The study measured savings by the actual savings while net profit after tax was the measure of organization performance. The analysis was done through regression to examine this relationship. The outcome of the analysis exhibited a positive, strong relationship between savings and business performance. The conclusion was that savings were important in determining business performance.

2.4.3 Debt Capital and Profitability

Salawu and Obafemi (2009) while examining how financing structure affects the profitability of Nigerian firms listed at the stock exchange, using models of fixed effect, ordinary least squares, and random effect as tools of analysis, the finding indicated that financing structure effect is insignificant to profitability, but a positive relationship between profitability and short-term debt existed. In addition, the use of equity financing has a positive correlation with profitability. Results further provided negativity in the relationship between the ratio of total debt to total assets and profitability. Shubita and Alsawalhah (2012) also studied on the effect of debt financing on the performance of firms. Their study revealed that a significantly negative relation exists between debt and profitability. These showed that an increase in the debt position was associated with a decrease in profitability thus the higher the debt the lower the profitability of the firm. It was concluded that financing structure decision is crucial for a business organization that is in need of maximizing returns. The study recommended that firms should use optimal financing structure which is made of debt and equity and that is able to minimize the cost of capital.

Habib et al. (2016) looking at the effect of debt on profitability in Pakistan's non-financial sector and using random effect regression as a tool of analysis, result of the study indicated negativity in the relationship between short term debt, long term debt, total debt, and return on assets but which is significant. The conclusion was that financing structure decision making is crucial for the success of an organization. An organization's profitability will depend on choosing the right percentage of debt and equity in the structure of capital. It was recommended for the firms to use internal financing or other sources of financing as opposed to debt financing.

Ramadhan and Trenggana (2014) examined the effect of debt on profitability within telecommunication sector. The study aimed at knowing how short-term debt and long-term debt influence profitability. Using regression model, the finding showed lack of effect of both short-term debt and long-term debt on return on equity and therefore stated that debt does not affect

the return on equity. The study concluded that other factors other than debt also affect profitability. The study recommended companies to take good financial management strategies so that the business can generate huge profits to cover the debt.

Wainaina (2014) in a study on the relationship between leverage and financial performance of the top 100 SMEs in Kenya. Using a cross-sectional research design as well as multiple regressions in the analysis, the study concluded that leverage had a significant positive relationship to the financial performance of SMEs in Kenya. From the study, it was recommended that MSEs should use moderate debt levels in the financing structure. Chepkemoi (2013) studied the analysis of the effect of financing structure on the financial performance of SMEs in Nakuru town, Kenya. Employing multiple regression approach and descriptive statistics as tools of analysis, result signified that there is a negative relationship between financing structure and profitability.

2.4.4 Moderating effect of business size on financing structure and profitability

A review of literature on corporate financing has postulated firm size as a key determinant of financing structure. Specifically, firm size which refers to the production and turnover capacities possessed by a firm (Surajit & Saxena, 2009); is positively associated with corporate gearing levels. In undertaking these studies, the ratio of sales to total assets has been used to measure firm size. Scholars have accredited this relationship to the fact that lenders often view larger businesses as less risky consumers of credit because of their superior collateral structure (Mule & Mukras, 2015).

The moderating effect of size on the leverage and profitability relationship is positive in small firms and negative in large firms (Vithessonthi & Tongurai, 2015). This is because of the difference in information asymmetry between large and small firms. Vithessonthi and Tongurai (2015) in a study of Thai firms, observed that the link between profitability and leverage is positive for small firms and negative for medium and large firms. In large firms, the negativity

is stronger than in medium-sized firms. Gonzalez and Gonzalez (2012) while studying the firm size and financing structure, reached a different conclusion by arguing that in large firms, information asymmetry is lower. Therefore in smaller firms, the profitability and leverage link is expected to be negative while in larger firms the link is positive. The strength of the relationship is expected to increase as firms approach either end of the size spectrum since the intensity of information asymmetry and size are directly proportional. Gonzalez and Gonzalez (2012) reported a negative relation across small, medium, and large size firms.

BAYYURT and Gokhan (2008) state that the size of the firm affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms. Big firms have more competitive power when compared to small firms in fields requiring competition. Since they have a bigger market share, big firms have the opportunity to profit more. In addition to this, big firms can seize the opportunity to work in the fields which require high capital rates since they have larger resources, and this situation provides them the opportunity to work in more profitable fields with little competition. Jaggi and Gul (1999) studied moderating effects of size on the relationship between investment opportunities, free cash flow, and debt borrowing. Their results revealed that there is a positive relationship between debt and free cash flows for low investment opportunity set firms when firm size is high. They also found that size is a significant moderator to the relation between investment opportunities, free cash flow, and performance. However, this research proposes that financial structure and profitability relation can vary within different firm sizes. Since, larger firms generate high and less volatile profits with strong liquidity, so their risk premium will also be lower comparatively. Similarly, information is less asymmetric in the case of larger firms that also decreases their uncertainty level. Moreover, larger firms also hold high tangible assets that they can use as collateral while borrowing external debt. Consequently, these larger firms access the debt market easily at a lower cost to gain tax advantages. So, per the trade-off theory, one can anticipate positive leverage performance relations for large size firms.

Musambali and Tarus (2013) in their study on whether a firm profile influences financial access among small and medium enterprises in Kenya. Using multiple regression analysis, they found that firm profiles such as ownership structure; firm size; business type, and age of business have an influence on access to finance by SMEs. Besides, small firms may have less power than large firms; hence they may find it difficult to compete with large firms particularly in highly competitive markets. On the other hand, as firms become larger, they might suffer from inefficiencies, leading to inferior financial performance. Theory, therefore, is equivocal on the precise relationship between size and performance (Majumdar, 1997).

2.5 The Conceptual Framework

This section presents conceptual framework that shows the hypothetical relationship between variables under study.

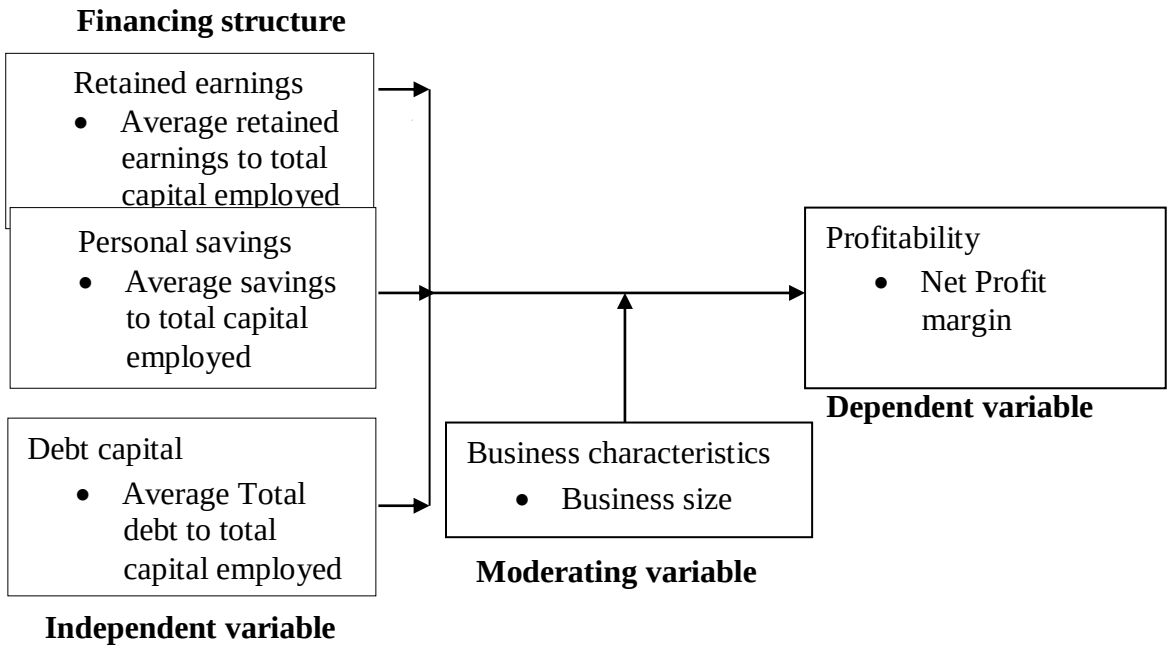

Figure 2.1: Conceptual Framework. Source: (Reviewed literature, 2020)

In this study, financing structure is represented by retained earnings, personal savings, and debt capital. The cause-effect relationship for each component of financing structure is shown. Independently, retained earnings, personal savings, debt capital are assumed to have a

relationship with profitability. The joint cause-effect relationship of the three independent variables and the dependent variable is also shown. Financing structure variables were measured using operationalized financial ratios namely total retained earnings to total capital ratio, total savings to total capital ratio, and total debt to total capital ratio respectively. The dependent variable was measured using net profit margin where the net profit margin was operationalized as a ratio of total profit after tax to total sales. The framework also presents a moderating variable of business size as a business characteristic that has been identified through researchers as having an influence on the cause-effect relationship between profitability and financing structure but for this study, the moderating variable effect was held constant and therefore was not analyzed.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction.

This chapter explains the various approaches used in carrying on with this study. Research design and population of study have been explained, including the sample size, the process of sampling, and the tools, approaches that were used in the collection, presentation, and analysis of data.

3.2 Research Design.

Glass and Hopkins (1984) states that a research design is a program that guides the researcher in the process of collecting, analyzing, and interpreting the data. The main function of the descriptive survey design is to explain the situation the way it appears currently. It allows obtaining of data through interviews or supplying questionnaires to sampled persons (Kombo, 2003). A descriptive survey design was used for this study to assess if the financing structure of micro and small enterprises affect profitability. This research design was chosen because of its high degree of representativeness and the ease in which a researcher will obtain the participants' opinion, it involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data collection

3.3 Target Population

Cooper (2003) explains a population to be all collected items on which we intend to inference over. This study was carried out in Nakuru central business district. The target population was 1,249 comprising all micro and small enterprises that were situated along Kenyatta Avenue and had been registered as of 1st July 2017 by Nakuru Municipality. The choice of this avenue was triggered by fact that it is located centrally within the town and a bigger number of micro and small enterprises stretch along this avenue (Municipal government of Nakuru, 2017). It was also convenient to the researcher because it was easily accessible and less costly in terms of transportation costs.

3.4 Sampling and sample size

3.4.1 Sample size

To arrive at a sample size used in the study, the researcher applied a sampling formula by Yamane (1967). When used, out of the target population of 1,249 MSEs, a sample size of 302 MSEs was obtained. It was applied as follows:

N = total population of People in the study

n= sample size

e = Tolerance at the desired level of confidence, probability level of α= 0.05

The result is as shown below:

n= 1,249/ (1+ (1,249*0.05^2))

n= 302

3.4.2 Sampling procedure

In selecting the respondents for the study, the researcher employed a systematic sampling design by Madow and Madow (1944) where every K^{th} MSE along the avenue was identified to become part of the sample size. The respondents were the owners of these enterprises. The formula used in picking the respondents was applied as follows:

K^{th} item = N/n = 1,249/302

= 4^{th} MSE

N =Target population

n =Sample size

3.5 Data Collection Procedures

The study relied on primary data. Data was obtained from the owners of the MSEs sampled out as respondents. Data was collected by the use of structured questionnaires, with closed questions. This instrument of data collection enabled the researcher to gather data from a large sample and also uphold confidentiality. Data covering a period of within 2011-2017 and for those businesses that kept their financial records were used. This meant that the information obtained was enough

to be considered for generalization purposes. Questionnaires were self-administered and others were by drop and pick later for those MSE owners that were not available at the time of going to the field to collect data. This enabled the respondents to have enough time at their convenience in responding to the questions.

3.6 Validity and reliability test

The ability of the research instrument to measure what it is supposed to be is the validity (Oso & Onen, 2009). The test for content validity together with construct validity was undertaken by the researcher. Content validity was concerned with whether a test included all relevant facets. A pilot study among ten business owners was performed to measure content validity. Mugenda and Mugenda (2003) puts it that a successful pilot study uses 1% to 10% making consideration of the sample size, wherewith large sample the percentage is small. This was carried out on kiosk owners and shop owners found along the street between KFA and Evans hospital roundabouts, Nakuru in which respondents were required to respond to the questionnaire so that any challenge identified in questions be corrected before the main data collection activity commenced. These shops and kiosks were picked because of the similarity in characteristics with those along the main avenue to be used during the main study.

For reliability, Mugenda and Mugenda (2003) explains it as the extent to which a research instrument measured consistently a variable over repeated trials. Cronbach alpha coefficient was used in testing for reliability from the data of the pilot study. The outcome was compared to the value of 0.7 (George & Mallery, 2003; Saunders et al., 2009) and which was over 0.7. This implied that the instrument of research was reliable.

3.7 Data Presentation and Analysis

Data collected was coded, tallied, and summarized then presented using tables and charts. A computerized data analysis package known as Statistical Package for the Social Science (SPSS) version 21was used for data entry and analysis. Descriptive statistics of frequencies,

percentages were used in analyzing hence giving an overview of the relationship between the variables under study. Inferential statistics of correlation coefficient and regression were applied in the testing of the hypothesis. A correlation was used to determine the direction of the effect of the independent variables on the dependent variable. Simple regression was applied in establishing the cause-effect of each of the independent variables to the dependent variable. Multiple regression was also used to determine the joint cause-effect of the independent variables on the dependent variable. The result was for responding to the hypothesis under study. A regression model that guided the analysis was in the following form:

The first hypothesis; $H_0$1: Retained earnings have no significant effect on the profitability of MSEs, was tested using

$$Y = a + \beta_1 X_1 + \epsilon$$

The second hypothesis; $H_0$2: Personal savings have no significant effect on the profitability of MSEs, was tested through

$$Y = a + \beta_2 X_2 + \epsilon$$

The third hypothesis; $H_0$3: Debt capital has no significant effect on the profitability of MSEs, was tested using

$$Y = a + \beta_3 X_3 + \epsilon$$

The fourth hypothesis; $H_0$4: Joined retained earnings, personal savings, and debt capital has no significant effect on the profitability of MSEs. The following model was applied.

$$Y = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Where:

Y = Profitability, measured as a ratio of net profit margin

X_1= Retained earnings, measured as a ratio of average total retained earnings to average total capital used in the business.

X_2= Personal savings, measured as a ratio of average total savings used as capital to total capital used in the business.

X_3= Debt capital, measured as a ratio of average total debt capital to total capital used in the business.

a = Constant (y-intercept)

ϵ = Error term

β_1, β_2, and β_3 = The strength of the relationship between the variables.

Debt capital constituted the bank loan, trade credit, and bank overdraft for analysis.

The model significance was confirmed using the analysis of the variance (ANOVA) by the use of F statistics at a 95% confidence level. The coefficient of determination R^2 was used to show the contribution of the independent variable on the dependent variable.

In this study, the moderating variable, the size of the enterprise was not part of the analysis. It was held constant.

3.8 Operationalization of study variables

The following financial ratios for both independent variables and the dependent variable was calculated.

Table 3.1: Operationalization of the Variables

Variables	Notation	Name of the ratio	Measurement
Dependent Variable			
Profitability	Y	Net profit margin	$\frac{\text{Average net profit after tax}}{\text{Average total income}}$
Independent Variable			
Retained earnings	X_1	Retained earnings ratio	$\frac{\text{Average Retained earnings}}{\text{Average total capital employed}}$
Personal Savings	X_2	Personal Savings ratio	$\frac{\text{Average Savings}}{\text{Average total capital employed}}$
Debt capital	X_3	Debt ratio	$\frac{\text{Average total debt}}{\text{Average total capital employed}}$

CHAPTER FOUR
RESULTS AND DISCUSSION

4.1 Introduction

This chapter gives an analysis of the data collected. It also presents and discusses the findings of the study. It is divided into various sections namely: an overview of the data collected and analyzed; response about the demographic information; and the response concerning the general information.

4.2 Results of the Pilot Study

The study sought to determine the reliability of the research instruments. The results are as shown in Table 4.1.

Table 4.1: Cronbach Alpha for Reliability Assessments

Variables	Cronbach Alpha Values
Retained earnings	0.827
Personal savings	0.811
Debt capital	0.778

The result of the Cronbach alpha coefficient portrayed in Table 4.1 for the different items was in the ranges of 0.778 to 0.827. The instrument, therefore, met the recommended threshold of value above 0.7.

4.3 Response Rate

The study sought to establish the response rate of the respondents from the questionnaires that had been given out to them. The results are presented in Table 4.2

Table 4.2: Response Rate

Responses	Frequency	Percentage
Respondent	283	93.7
Non – Respondent	19	7.3
Total	**302**	**100**

Table 4.2 shows a high response rate. A total of 283 responses were received back, this translated to a 93.7% response rate. Nevertheless, fifteen questionnaires had been poorly done in which they had to be discarded from being used in the analysis. Therefore the remaining questionnaires that were used in the analysis were 268, translating into 88.7%. Njeru (2013) states that a 50% to 75% response rate is sufficient enough for data analysis and so based on this assumption, the response rate of 88.7% was therefore very good and was considered useful to make conclusions for the study. This was associated with the procedures of data collection, where the researcher pre-notified the potential participants of the intended survey, utilized a self-administered questionnaire where the respondents completed, and immediately after, they were picked. Follow up calls were also made to clarify queries in the questionnaires.

4.4 Profile of Respondents

The descriptive result of the study was presented using tables and charts. It was then analyzed by the use of descriptive statistics tools of frequency and percentage. The profile of respondents for the study considered was the response rate, the gender of the response, the form of business ownership, length of enterprise operation, the income level of the enterprise, and the number of employees in the enterprise.

4.4.1 Gender of the respondents

The research sought to establish the composition of the MSEs as per the gender. The results are provided in Table 4.3.

Table 4.3: Gender of respondents

Gender	Frequency	Percentage
Male	120	45.0
Female	148	55.0
Total	**268**	**100.0**

In table 4.3, it was established from the results that a fair majority of the MSEs 148(55%) were owned by the female gender while 120(45%) were owned by the male gender. This could be

implied that the ownership of MSEs is balanced in terms of gender and that the female gender has gained more interest in the running of MSEs.

4.4.2 Form of business ownership

The research also sought to establish the different forms of ownership of the enterprises by the respondents. Ownership for consideration was sole ownership, partnership, and company. The result is presented in Table 4.4

Table 4.4: Response to business ownership

Business Owner	Frequency	Valid Percent
Sole ownership	141	52.5
Partnership	67	25.0
Company	60	22.5
Total	**268**	**100.0**

From table 4.4 with regards to the forms of business ownership, it was established as per the result that most MSEs 141(52.5%) were owned by individuals, 67(25%) were in partnership, while 60(22%) were companies. The result indicates that a majority of the MSEs belonged to individuals themselves who took full control of them in decision making.

4.4.3 Length of enterprise operation

The research sought to determine how long the enterprise had been in operation. The result was presented in Table 4.5.

Table 4.5: Length of enterprise operation

Length of operation	Frequency	Valid Percent
Below 1	20	7.5
1-3	74	27.5
4-5	67	25.0
over 5	107	40.0
Total	**268**	**100.0**

With regards to the length of operation of the MSE, the result of table 4.5 revealed that a majority of the MSEs 107(40%) had been in operation for more than 5 years, 74(27%) had been in operation in the range of 1 to 3 years, 67(25%) had been operating 4 to 5 years while 20(7.5%) had only operated less than 1 year. The result implies that there was parity among respondents with slight dominance in the over 5 years. It informs that most of the MSEs had been in operation long enough to give reliable information on the performance of MSEs.

4.4.4 Income level of MSEs

The study sought to establish the level of the monthly income of the MSEs. The result was presented in Table 4.6

Table 4.6: Monthly income level

Monthly income	Frequency	Valid Percent
Below 10,000	80	30.0
10,000-50,000	88	32.8
51,000-100,000	80	30.0
Over 100,000	20	7.2
Total	**268**	**100.0**

On monthly income, it was established from table 4.6 that there was a fair distribution of MSEs' monthly income, with 88(32%) having an income of 10,000 to 50,000, 80(30%) having 51,000 to 100,000 and the same distribution of 80(30%) was also portrayed for MSEs getting below 10,000 monthly incomes. Only the MSEs with over 100,000 as monthly incomes was less dominated with a representation of 20(7.2%). It implies that MSEs were not performing that well in terms of income generated in the business.

4.4.5 Number of employees

The researcher sought to establish the number of employees that are engaged in the daily running of MSEs. The results were presented in Table 4.7

Table 4.7: Number of employees

Number of employees	Frequency	Percentage
1-10	174	64.9
11-50	94	33.1
51 and over	0	0.0
Total	**268**	**100**

From the result displayed in table 4.7, it was established that 174(64.9%) of the MSEs have employees in the range of 1 to 9, 94(33.1%) of MSEs have engaged employees numbering 11 to 50. This means that most of the MSEs only required a few manpower to carry out the tasks.

4.5 Descriptive statistics with regards to variables under study

This section gives an analysis of the descriptive findings and discussion about the financing structure and profitability of MSEs. The results were presented using frequencies, percentages, mean and standard deviation.

4.5.1 Financing structure of MSEs

The researcher also sought to determine which sources of financing are used by the MSEs. The result is presented in Table 4.7

Table 4.8: Sources of Financing in Business

Source of financing	Frequency	Percentage
Retained earnings	168	62.7
Personal savings	241	91.8
Bank loan	119	44.4
Trade credit	137	51.1
Bank overdraft	40	14.9

From table 4.8 above, revealed that personal savings were the most used (91.8%) by MSEs, retained earnings was also used (62.7%). This reveals that MSEs made more use of equity financing as sources of finance and less of debt capital.

4.5.2 Utilization of the sources of finance in financing the business.

The researcher also sought to establish the frequency by which the sources of finance are utilized by MSEs. A Likert scale of 1(not used) to 5(most frequently used) was applied. Table 4.9 presents the result of the analysis.

Table 4.9: Utilization of the sources of financing.

	Level of utilization				
	1	**2**	**3**	**4**	**5**
Retained earnings	-	2.5	22.5	42.5	32.5
Personal savings	2.5	17.5	37.5	32.5	10
Bank loans	2.5	35	32.5	30	-
Trade credit	2.5	42.5	12.5	25	17.5
Bank overdrafts	40	45	2.5	7.5	5

The result in table 4.9 informs that MSEs frequently considered retained earnings (42.5%) to finance the business, personal saving was considered on average (37.5%) in financing the business. Bank loans (35%), trade credit (42.5%), and bank overdraft (45%) were considered least in financing the business. This may be associated with the cost involved in securing such financing.

4.5.3 Amount of cash flow in the business

The study sought to determine the worth of the business in the period under study. Mean and the standard deviation was used as measuring tools. The purpose of this was to enable the computation of ratios of the variables under study. The result of the average worth of the MSEs during the said period is in table 4.10.

Table 4.10: Amount of cash flow in the business

	MIN	MAX	MEAN	STD
Retained earnings	50,000.00	3,685,714.00	841,219.00	768,083.00
Personal savings	40,000.00	1,000,000.00	347,440.00	297,068.75
Bank loan	150,000.00	3,000,000.00	953,819.44	867,690.24
Trade credit	10,000.00	11,642,857.14	146,378.30	2,970,707.91
Total Income	110,000.00	6,630,000.00	1,792,684.21	1,832,699.16
Other expenditures	30,000.00	1,620,000.00	206,041.96	295,431.45
Net profit	56,666.67	5,214,285.71	1,268,547.62	1,430,038.45

About the worth of the business in terms of cash flow distribution in the enterprises, the results in table 4.10 indicate that on average Net profit in the business was worth Kshs 1,268,547.62 with a standard deviation of Kshs 1,430,038.45. In the same period, MSEs were on average worth Kshs 206,041.96 of general expenses with a standard deviation of Kshs 295,431.45. During the same period under study, income in the business was worth an average of Kshs 1,792,684.21 with a standard deviation of Kshs 1,832,699.19. Retained earnings were worth an average of Kshs 841,219.00 with a standard deviation of Kshs 768,083.00. Besides those MSEs that used personal savings as a source of financing, on average it was worth Kshs 347,440.00 with a standard deviation of Kshs 297,068.75. Long term loan from banks was worth an average of Kshs 953,819.44 with a standard deviation of Kshs 867,690.24. Finally, trade credit was worth an average of Kshs 146,378.30 with a standard deviation of Kshs 2,970,707.91. Using the above, various computations were computed as follows;

$$\text{Net profit margin ratio} = \frac{\text{Average net profit after tax}}{\text{Average total income}}$$

$$= \frac{1{,}268{,}547.62}{1{,}792{,}684.21} = 0.71$$

$$\text{Retained earnings ratio} = \frac{\text{Average Retained earnings}}{\text{Average total capital employed}}$$

$$= \frac{841,219.00}{2,288,916.27} = 0.37$$

$$\text{Personal savings ratio} = \frac{\text{Average Savings}}{\text{Average total capital employed}}$$

$$= \frac{347,440.00}{2,288,916.27} = 0.15$$

$$\text{Debt ratio} = \frac{\text{Average total debt}}{\text{Average total capital employed}}$$

$$= \frac{1,100,257.27}{2,288,916.27} = 0.48$$

From the results obtained above, the following can be stated; MSEs received an above-average profit concerning the duration under study. This is represented by 71% of the total sales or income. It showed that MSEs were performing better off on average. In the same period under study, the result showed that about the total capital used to finance the MSEs, a bigger contribution was through debt financing. This is represented by 67% of the total capital used by MSEs. Only 33% was from equity capital. This means that MSEs relied most on debt financing as a source of financing as compared to equity capital. In this case, debt capital was composed of a bank loan of borrowed capital from financial institutions, trade credit, and an overdraft. On the other hand, equity capital was composed of retained earnings in the enterprise and personal savings by the owner of the business.

4.5.4 Profitability of MSEs

The study sought to establish the profitability of MSEs by using a scale of 1(strongly disagree) to 5(strongly agree). The result is presented in Table 4.11

Table 4.11: Profitability

Profitability	Level of agreement				
	1	2	3	4	5
The current profitability status increase after the use of retained earnings.	-	-	8.3	61.1	30.6
The use of Personal savings in financing the business increases profitability	-	3.7	-	63	33.3
The high sales growth rate is due to the use of bank loan	-	5.2	10.2	58	26.6
The use of Trade credit tends to increase profitability in the enterprise.	-	23.8	-	76.2	-
The use of overdraft in the enterprise affect the profitability of the business	-	4.7	7.4	56.7	31.2
In general, the financing structure is used to influence the profitability of the enterprise.	-	-	6.5	41.3	52.2

The results of table 4.11 revealed that the majority of respondents were in agreement with the statements asked about profitability. Retained earnings (91.7%), personal savings (96.3%), trade credit (76.2%), and overdraft (87.9%) affect the profitability of MSEs. In similarity, respondents agreed that an increase in sales was attributed to using a bank loan (84.6%). They agreed that in general, financing structure influences the profitability of MSEs. The results imply a balanced distribution for the topic under study.

4.6 Inferential statistics and discussions of the variables under study

This section gives an analysis of the relationship between independent variables and the dependent variable.

4.6.1 Correlation Analysis

To determine the non-causal relationship between the independent variables (Retained earnings, personal savings, and debt capital) and dependent variable (profitability), Pearson's correlation analysis was employed. Table 4.12 presents the results of the correlation.

Table 4.12: Correlation matrix

		Profitability	**Retained earnings**	**Personal Savings**	**Debt Capital**
Pearson Correlation®	Profitability	1.000	0.579	0.138	-0.009
	Retained Earnings	0.579	1.000	0.313	0.355
	Personal Savings	0.138	0.313	1.000	0.210
	Debt Capital	-0.009	0.355	0.210	1.000
Sig. (1-tailed)	Profitability	.	0.000	0.036	0.040
	Retained Earnings	0.000	.	0.078	0.029
	Personal Savings	0.036	0.078	.	0.194
	Debt Capital	0.040	0.029	0.194	.
N=268, α= 0.05					

4.6.1.1 Correlation between retained earnings and profitability

The study established the relationship that existed between retained profit and profitability in MSEs. According to the results in table 4.12, there existed a positive and statistically significant ($r = 0\ .579$; $p < 0.05$) correlation between retained earnings and profitability in MSEs. This meant that an increase in the use of retained earnings would increase the profitability of MSEs. Thus, it could be deduced that retained profit injection results in profitability in the long run. The findings go against Thuranira's (2014) study on listed companies at the Nairobi Securities Exchange that emphasized the lack of importance of retained earnings. Besides, the findings agree with observations by Khan (2012). The study had found that the more retained earnings used in firms, the more is the increased chances of growth through increased profitability.

4.6.1.2 Correlation between personal savings and profitability

The study further determined the relationship between personal savings and profitability in MSEs. The results in table 4.12 reveal a positive and statistically significant ($r = 0.138$; $p < 0.05$) correlation between personal savings and profitability in MSEs. This implied that personal savings as a source of capital result in increased profitability if injected in the business. The findings concur with those of Wardhana (2012) in a study on the relationship between personal savings and profitability of nonfinancial SMEs established that savings of an enterprise have a significant influence on the profitability of SMEs. The study also agrees with that of Okumu (2013) who examined the relationship between business savings and business performance of listed firms in NSE and established that there was a positive, strong relationship between savings on business performance.

4.6.1.3 Correlation between debt capital and profitability

The study went further in evaluating the correlation between debt capital and profitability in MSEs. The correlation results in table 4.12 reveal that a negative, statistically significant ($r = -0.009$; $p < 0.05$) correlation existed between debt capital and profitability. It implied that debt capital influenced profitability in the MSEs. The findings concurred with that of Touseef (2014) who, while studying the cement sector of Pakistan emphasized that profitability had an inverse relation with the amount of liability in a company's financing structure. It also concurs with Rono's (2015) in a study on the financial performance of listed commercial banks in Kenya, revealed a negative relationship between debt and financial performance though significant. On the other hand, the findings are against that by Githire and Muturi (2015) in their study that revealed a positive, significant relationship between debt on financial performance.

4.6.2 Regression analysis

Simple regression analysis was used to examine the effect of each independent variable on the dependent variable and in testing the hypothesis. Multiple regression analysis was used to

examine the joined effect of the independent variables on the dependent variable and also to test the research hypotheses. This is explained as under:

4.6.2.1 Effect of retained earnings on the profitability of MSEs.

The first objective of the study was to establish the effect that retained earnings had on the profitability of micro and small enterprises within the Nakuru central business district. The hypothesis guiding this study was that $H_0$1: Retained earnings have no significant effect on the profitability of MSEs in the Nakuru Central Business District. Results are presented in the table

Table 4.13: Effect of retained earnings on the profitability of MSEs.

Model Summary

Model	R	R Square	Adj. R Square	S.E
	0.623[a]	0.388	0.266	0.3206

a. Predictors: (Constant), Retained Earnings

b. Dependent Variable: Profitability

ANOVA[a]

	Sum of Squares	df	Mean Square	F	Sig.
Regression	17.383	3	5.794	56.803	0.033
Residual	27.140	264	0.102		
Total	44.523	267			

a. Predictors: (Constant), Retained Earnings

b. Dependent Variable: Profitability

Coefficients[a]

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	S. E	Beta		
Constant	2.423	0.456		5.313	0.046
Retained Profit	0.667	0.222	0.672	3.002	0.033

b. Dependent Variable: Profitability

From table 4.13, the regression outcome, R-Square of 0.388 shows that as an effect, retained earnings contributed to an extent of (38.8%) for the dependent variable which is the profitability of micro and small enterprises. The remaining percent of (61.2%) was attributed to the error term as well as other extraneous variables not covered by the study.

In consideration of the ANOVA in which F statistic was used to test whether the model was able to predict that independent variable (retained earnings) affects profitability, results in table 4.13 indicate that the mean square of the residual (0.102) was very small in comparison to the mean square of the regression (5.794). Further, the results indicate that the $F_{(3, 264)} = 56.803$ was statistically significant ($p<0.05$). These implied that the data model fitted the actual data significantly and the coefficients were not equal to zero. Therefore the model was significantly able to predict a change in the dependent variable (profitability) as a result of the predictor variable (retained earnings).

Furthermore, from table 4.13 above, the results inform of the existence of a positive statistically significant relationship between retained earnings and profitability of micro and small enterprises in the Nakuru central business district ($\beta = 0.667$, $P<0.05$). It implies that when retained earnings are increased by an additional unit, the profitability of MSE in Nakuru CBD will increase by 0.667units. Thus, the null hypothesis ($H_0 1$) that "retained profit has no significant effect on the profitability of micro and small enterprise in Nakuru Central Business District" was rejected and

it was concluded that "retained earning has a significant effect on the profitability of micro and small enterprises in Nakuru Central Business District". The results are inconsistent with those of Thuranira's (2014) study on listed companies at the Nairobi Securities Exchange that emphasized the lack of importance of retained earnings. Also, the findings agree with observations of the study done by Khan (2012). The study had determined that the more the retained earnings used in firms, the more is the increased chances of growth through increased profitability.

$Y= 2.423 + 0.667X_1$

4.6.2.2 Effect of personal savings on the profitability of MSEs

The second objective was of determining the effect of personal savings on the profitability of micro and small enterprises in the Nakuru central business district. It was guided by the following hypothesis; $H_0$2: Personal savings have no significant effect on the profitability of MSEs in the Nakuru Central Business District. Results are presented in Table 4.14

Table 4.14: Effect of personal savings on the profitability of MSEs

Model Summary

Model	R	R Square	Adj. R Square	S.E
	0.601[a]	0.423	0.296	0.3406

a. Predictors: (Constant), Personal Saving

b. Dependent Variable: Profitability

ANOVA[a]

	Sum of Squares	df	Mean Square	F	Sig.
Regression	5.611	3	1.870	15.081	0.001
Residual	32.736	264	0.124		
Total	38.347	267			

a. Predictors: (Constant), Personal Savings

b. Dependent Variable: Profitability

Coefficients[a]

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	S. E	Beta		
Constant	2.837	0.512		5.542	0.042
Personal savings	0.216	0.032	0.306	6.750	0.016

b. Dependent Variable: Profitability

From the results of the model summary in table 4.14 above, the R-Square = 0.423 the effect of personal savings contributed to an extent of (42.3%) for the dependent variable (profitability) of micro and small enterprises. The remaining percentage was attributed to other variables not forming part of the study. Additionally, results indicate that the mean square of the residual (0.124) was very small compared to the mean square of the regression (1.870). Further, the results indicate that the $F_{(3, 264)} = 15.081$ was statistically significant ($p<0.05$). This implies that the data model fitted the actual data significantly and the coefficients are not equal to zero. Thus the model significantly predicted a change in the dependent variable as a result of the predictor variable. Furthermore, as shown in table 4.14, it was also established that the relationship between personal savings and profitability of micro and small enterprises in Central Business District is positive and statistically significant ($\beta = 0.216$, $P<0.05$). A beta coefficient of 0.216 indicates that when personal savings increase by an additional shilling or unit, the profitability of MSE increases by 0.216. Thus the null hypothesis ($H_0 2$) that "personal savings have no significant effect on the profitability of micro and small enterprise in Central Business District" was rejected by concluding that "personal savings has a significant effect on the profitability of micro and small enterprise in Nakuru Central Business District". This result is consistent with those of Okumu (2013) which examined on savings and business performance of listed firms in NSE and stated that profitability had a positive relationship with savings.

$Y= 2.837 + 0.216X_2$

4.6.2.3 Effect of debt capital on profitability of MSEs

The third objective was evaluating the effect of debt capital on the profitability of micro and small enterprises in the Nakuru Central Business District. The hypothesis to guide this objective was as follows; $H_0$3: Debt capital has no significant effect on the profitability of Micro and Small enterprises in the Nakuru Central Business District. Results are presented in Table 4.15

Table 4.15: Effect of debt capital on profitability of MSEs

Model Summary

Model	R	R Square	Adj. R Square	S.E.
	.605[a]	.330	.280	.5734

a. Predictors: (Constant), Debt Capital

b. Dependent Variable: Profitability

ANOVA[a]

	Sum of Squares	df	Mean Square	F	Sig.
Regression	15.642	3	5.794	35.987	0.039
Residual	42.504	264	0.102		
Total	58.146	267			

a. Predictors: (Constant), Debt Capital

b. Dependent Variable: Profitability

Coefficients[a]

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	S. E	Beta		
Constant	3.259	0.523		6.231	0.039
Debt Capital	-0.198	0.048	-0.243	-4.142	0.035

b. Dependent Variable: Profitability

From the result in table 4.15 above, the R-square of 0.330 shows that debt capital contributed (33.0%) for the dependent variable of profitability of micro and small enterprises in the Nakuru Central Business District. the remaining percentage being contributed by other variables not part of the study. Additionally, the result provides that the mean square of the residual (0.102) was on average small compared to the mean square of the regression (5.794). More so, results also indicate that the $F_{(3, 264)} = 35.987$ was statistically significant ($p<0.05$). This implies that the data model fitted the actual data significantly and the coefficients are not equal to zero. Thus the model significantly predicts change in the dependent variable as a result of predictor variables.

It was also revealed that there exists a significant negative relationship between debt capital and profitability of micro and small enterprises ($\beta = -0.198$, $P<0.05$). A beta coefficient of -0.198 indicates that when debt capital increases by an additional unit, the profitability of MSE decreases by 0.198. Thus the null hypothesis ($H_0 3$) that "debt capital has no significant effect on the profitability of micro and small enterprise "was rejected by concluding that debt capital has a significant effect on the profitability of micro and small enterprise in Nakuru Central Business District. The results are consistent with those of Touseef's (2014) study on the cement sector of Pakistan which emphasized that profitability had an inverse relation with the amount of liability in a company's financing structure. It also concurs with Rono's (2015) study on the financial performance of listed commercial banks in Kenya which provided a negative relationship between debt and financial performance through significant. On the other hand, the findings are

against that by Githire and Muturi's (2015) study which gave a positive, significant relationship between debt on financial performance.

$Y= 3.259 – 0.198X_3$

4.6.2.4 Joint Effect of Retained earnings, personal savings and Debt capital on Profitability of MSEs

As an objective, the study was also interested in establishing the joint effect of retained earnings, personal savings, and debt capital on the profitability of MSEs in CBD. The following was the hypothesis to be tested. $H_0$4: Joint retained earnings, personal savings and debt capital has no significant effect on the profitability of MSEs in the Nakuru Central Business District. The result is presented in Table 4.16

Table 4.16: Joint Effect of Retained earnings, personal savings, and Debt capital on Profitability.

Model Summary

Model	R	R Square	Adj. R Square	S.E
	0.612[a]	0.376	0.278	0.331

a. Predictors: (Constant), Debt Capital, Personal savings, Retained Profit

b. Dependent Variable: Profitability

ANOVA[a]

	Sum of Squares	df	Mean Square	F	Sig.
Regression	15.738	3	5.246	43.355	0.023
Residual	31.944	264	0.121		
Total	47.682	267			

a. Predictors: (Constant), Debt Capital, Personal savings, Retained Profit

b. Dependent Variable: Profitability

Coefficients[a]

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	S. E	Beta		
Constant	2.324	0.462		5.030	0.046
Retained Profit	0.576	0.213	0.572	2.704	0.029
Personal savings	0.131	0.044	0.121	2.977	0.021
Debt Capital	-0.164	0.048	-0.143	-3.416	0.028

a. Dependent Variable: Profitability

From the multiple regression results, as shown in Table 4.16, the R^2 of 0.376 informs that the joint effect of retained earnings, personal savings, and debt capital contributed to an extent of (37.6%) for the dependent variable (profitability) of micro and small enterprises. The remaining proportion (62.4%) being related to the error as well as other extraneous variables. Besides, the value for R= 0.612 was highly sufficient to indicate that the model adjusted with more variables being incorporated in trying to determine the joint effect of the independent variables on the dependent variable among Micro and Small Enterprises in Nakuru Central Business District.

The results of the ANOVA inform that the mean square (0.121) of the residuals was very small compared to the mean square (5.246) of the regression. Further, the results indicate that the $F_{(3, 264)} = 43.355$ was statistically significant ($p<0.05$). This indicated that the overall model was a good fit and the coefficients are not equal to zero. Thus the model significantly predicts change in the dependent variable as a result of predictor variables.

According to the equation by taking all other factors constant at zero profitability will increase by 2.324 units. The results also indicate that there exists a positive statistically significant relationship between retained earnings and profitability of micro and small enterprises (β = 0.576, $P<0.05$). This implies that when retained earnings increase by an additional shilling, the profitability of MSE in Nakuru CBD increases by 0.576. It was also established that the

relationship between personal savings and profitability of micro and small enterprises is positive and statistically significant ($\beta = 0.131$, $P<0.05$, and that when personal savings increases by an additional shilling or unit, the profitability of MSE increases by 0.131. It was also revealed that there exists a significant negative relationship between debt capital and profitability of micro and small enterprises with a statistically significant of ($\beta = -0.164$, $P<0.05$) in that when debt capital increases by an additional shilling or unit, the profitability of MSE decreases by 0.164.

From the regression results, the following regression model was derived;

$Y= 2.324 + 0.576X_1 + 0.131X_2 – 0.164X_3$

4.7 Summary of results of tested hypotheses

The summary of the results of the test of hypotheses in Table 4.17 indicates that based on the beta coefficients (β) retained earnings has the most influence on profitability with debt capital following secondly while personal savings has the least influence on the profitability of Micro and Small Enterprises in Nakuru Town Central business district.

Table 4.17: Summary of results of test of hypotheses

Hypothesis	Results	Conclusion
$H_0$1: Retained earnings have no significant effect on the profitability of Micro and Small Enterprises in the Nakuru Central business district.	Statistically significant effect of retained profit on profitability ($\beta = 0.667$, $p<0.05$)	$H_0$1 Rejected
$H_0$2: Personal savings has no significant effect on the profitability of Micro and Small Enterprises in the Nakuru Central business district.	Statistically significant effect of own saving on profitability ($\beta = 0.216$, $p<0.05$)	$H_0$2 Rejected
$H_0$3: Debt capital has no significant effect on the profitability of Micro and Small Enterprises in the Nakuru Central business district.	Statistically significant effect of debt capital on profitability ($\beta = -0.198$, $p<0.05$)	$H_0$3 Rejected
$H_0$4: Joint retained earnings, personal savings and debt capital has no significant effect on the profitability of Micro and Small Enterprises in the Nakuru Central Business District.	Statistically significant effect of combined retained profit ($\beta= 0.576$, $p<0.05$), personal savings ($\beta= 0.131$, $p<0.05$) and debt capital ($\beta = -0.164$, $p<0.05$) on profitability	$H_0$4 Rejected

CHAPTER FIVE
SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the findings of the study and draws conclusions that form the basis of recommendations. It further provides suggestions for further study in line with the shortcomings identified in the study. The conclusions as discussed are aligned to the study objectives with their corresponding hypotheses.

5.2 Summary of findings

The overall objective was to establish the effect of financing structure on the profitability of Micro and Small Enterprises in the Nakuru Central Business District. The study used a descriptive research design with a sample size of 268 MSEs. Tests were carried out in support of the application of the regression analysis method, to analyze the nature and the degree of the relationships. Conclusions on the statistical significance between the various components of financing structure on profitability, measured by Net Profit Margin were drawn. The summary for each item based on the specific objectives of the study is explained as under.

The first objective was to establish whether there were retained earnings effects on the profitability of micro and small enterprises in the Nakuru central business district. The results from descriptive statistics revealed respondents agreed that the use of retained earnings increased the profitability of MSEs. Results from correlation analysis showed a positive and statistically significant ($r = 0.579$; $P<0.05$) relationship between retained earnings and profitability in micro and small enterprises. From the regression analysis, results indicated a positive statistically significant relationship between retained earnings and profitability of micro and small enterprises ($\beta = 0.667$, $P<0.05$). Therefore, we failed to accept the null hypothesis ($H_0 1$) that retained earnings has no significant effect on the profitability of the micro and small enterprise and concluded that retained earning has a significant effect on the profitability of micro and small enterprise in Nakuru Central Business District.

In the second objective, the study sought to determine whether personal savings affected the profitability of small and micro enterprises in the Nakuru central business district. The descriptive statistics results revealed that using personal savings in financing the business increases the profitability of MSEs. Results from correlation analysis showed that there existed a positive and statistically significant ($r = 0.138$; $p < 0.05$) relationship between personal savings and profitability in MSEs. Additionally, regression analysis results showed a positive relationship between personal savings and the profitability of micro and small enterprises which is statistically significant ($\beta = 0.216$, $P<0.05$). Thus we rejected the null hypothesis ($H_0 2$) that "personal savings has no significant effect on the profitability of micro and small enterprise and concluded that personal saving has a significant effect on the profitability of micro and small enterprise in Nakuru Central Business District.

The third objective was to evaluate whether the use of debt capital affects the profitability of small and micro enterprises in the Nakuru central business district. Results from descriptive statistics showed that the use of debt capital (bank loan, trade credit, and overdraft) affects the profitability of MSEs. The correlation results revealed the existence of a negative and statistically significant ($r = -0.009$; $p < 0.05$) relationship between debt capital and profitability. From the regression analysis, results showed a negative statistically significant relationship ($\beta = -0.198$, $P<0.05$) between debt capital and profitability of micro and small enterprises. Thus we failed to accept the null hypothesis ($H_0 3$) that "debt capital has no significant effect on the profitability of micro and small enterprise and concluded that debt capital has a significant effect on the profitability of micro and small enterprise in Nakuru Central Business District.

The last objective of the study sought to establish the joined effect of the three predictor variables on the profitability of small and micro enterprises in the Nakuru central business district. From the descriptive statistics, the result shows that the financing structure influences the profitability of the business. The regression result also revealed a statistically significant effect of the joined variables on profitability. Thus we rejected the null hypothesis ($H_0 4$) that "joint retained earnings, personal savings, and debt capital has no significant effect on the profitability of micro and small enterprises" and concluded that "joined effect of retained

earnings, personal savings and debt capital has a significant effect on the profitability of micro and small enterprises"

5.3 Conclusion

This study aimed to establish the effect of financing structure on the profitability of small and micro enterprises in the Nakuru central business district and was guided by four objectives. Based on the findings above, the following conclusions can be made.

In establishing the effect of retained earnings on the profitability of small and micro enterprises in the Nakuru central business district, results confirmed an existence of a positive, statistically significant relationship between retained earnings and profitability in micro and small enterprises. This indicates the importance of retained earnings in determining the profitability of micro and small enterprises. It can, therefore, be concluded that retained earnings positively influence the profitability of micro and small enterprises in Nakuru Central Business District and so it should always form a component of capital structure.

The second objective, determining whether personal savings affected the profitability of small and micro enterprises in the Nakuru central business district. Results showed that there existed a positive and statistically significant relationship between personal savings and profitability in micro and small enterprises. Therefore, the study concludes that personal savings have a positive significant effect on the profitability of micro and small enterprises in the Nakuru Central Business District. It is, therefore, an important component of the financing structure of MSEs.

The third objective was to evaluate whether debt capital had effects on the profitability of small and micro enterprises in the Nakuru central business district. From the results, the existence of a negative, statistically significant relationship between debt capital and profitability was observed. It is therefore concluded from the study that debt capital has a significant effect on the profitability of micro and small enterprises in Nakuru Central Business District though negatively. Therefore, debt capital should be very minimal in the financing structure if the micro and small enterprises intend to increase their profitability.

Lastly in establishing the joined effect of the three predictor variables on the profitability of small and micro enterprises in the Nakuru central business district. The result shows that the effect of the joint predictor variables is positive on the profitability of MSEs. It is therefore concluded that when joined, retained earnings, personal savings, and debt capital has a significant effect on the profitability of micro and small enterprises. It can therefore be concluded that financing structure in totality affects the profitability of micro and small enterprises in central business district.

5.4 Recommendations of the study

The findings of this study revealed that financing structure affects the profitability of micro and small enterprises in the Nakuru central business district. The study, therefore, recommends the following:

Micro and Small enterprises should continue using retained earnings and personal savings for purposes of increasing profitability before they opt for debt capital. This is because any increase in Retained earnings and personal savings leads to an increase in the profitability of micro and small enterprises, unlike debt capital that negatively affects the profitability of micro and small enterprises. In general financing structure to be adopted by micro and small enterprises should be that which has a positive influence on profitability.

5.5 Suggestion for further studies

This study concentrated on three components of financing structure as determinants of profitability of Micro and Small Enterprises in the Nakuru Central Business District. A further study, therefore, can be done by considering other components that make up the financing structure. A similar study could also be done on enterprises not covered by this study. Additionally, a study can be done for a similar number of observations to establish if the results would in any way be different from the current study. Finally, an effort could be made to analyze a larger sample than what was in this study.

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Appendix A: Questionnaire for the respondent

Instructions

Please respond to questions by ticking appropriately in the space provided.

SECTION 1: DEMOGRAPHIC INFORMATION

1. What is your gender?

Male ( ) Female ( )

2. What is your education level?

Secondary ( ) Under-graduate ( ) Post- graduate ( ) Others (specify) ( )

3. What form of business ownership do you run?

Sole-ownership ( ) Partnership ( ) Company ( )

4. How did you join the business environment?

Start-up ( ) Buyout ( ) Franchise ( ) Family business ( ) Others (specify) ( )

5. What is the monthly income in Kshs (000) in the business?

Below 10 ( ) 11- 50 ( ) 51- 100 ( ) Over 100 ( )

6. What is the number of employees in the business?

1- 10 ( ) 11- 50 ( ) 51 and Above ( )

SECTION 2: GENERAL INFORMATION

7. Which source of capital below does your business use in its operation?

Personal savings ( ) Retained earnings ( ) Bank loan ( )

Trade credit ( ) Bank overdraft ( )

8. What proportion of the total capital does the following source hold in the business?

	0%	1-10 %	11-30 %	31-50 %	51-70 %	71-100 %
Retained earnings						
Personal savings						
Bank loan						
Trade credit						
Bank overdraft						
Total capital(in percentage)	100	100	100	100	100	100

10. Please indicate your view on the utilization of the sources of finance below in financing the business by ticking appropriately.

Key: 1-Not used; 2-least used; 3-averagely used; 4-frequently; 5-most frequently used

Source	**Level of utilization**				
	1	2	3	4	5
Retained earnings					
Personal savings					
Bank loans					
Trade credit					
Overdraft					

11. How much has the business spent in the periods indicated below?

	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Retained earnings							
Personal saving							
Bank Loan							
Trade credit							
Overdraft							
Expenses							
Net profit							

12. Indicate the level of agreement with the following statements about financing structure on profitability by placing a tick appropriately.

1- Strongly disagree, 2- disagree, 3- Not sure, 4- Agree, 5- Strongly agree

Profitability	**Level of agreement**				
	1	**2**	**3**	**4**	**5**
The current profitability status increase after use of retained earnings.					
The use of Personal savings in financing the business increases profitability					
High sales growth rate is due to use of bank loan					
The use of Trade credit tend to increase profitability in the enterprise.					
Liquidity position of the enterprise affect profitability of the business					
In general Source of finance used influence the profitability of the enterprise.					

Appendix B: Registered SMEs in Nakuru CBD

SN	Business Name	Business Activity
1	Stan bookshop	School accessories
2	Muaki pharmacy	Selling drugs and clinical services
3	Muturi electricals	Phone accessories
4	Kuweka Trading LTD	Gas cylinders
5	Transmega chemist	Selling drugs
6	Holiday driving school	Training in driving
7	Neema opticians	Eye clinics
8	Gilgil green grocery	Selling vegetables and fruits
9	Mwaura fashion designers	Clothing
10	Omega optician	Eye clinic
11	Medix phamaceuticals	Selling drugs
12	Betacare chemist	Selling drugs
13	Mwangaza studio	Photo shop
14	Cutex saloon & kinyozi	Hair dressing and shaving
15	Shikpak hotel	Hospitality service
16	Ajabai butchery	Selling meat
17	Valley chemist	Selling drugs
18	Rift opticals	Eye clinic
19	Davies modern café	Food services
20	Riwell mobile shop	Selling phone and phone accessories
21	Monica Duves shop	Selling duves and bedsheets
22	Devi's stationery & computers	Printing and internet services
23	Care chemist	Selling drugs
24	Armster enterprise	Selling phone and phone accessories
25	Tuskeys supermarket	Selling all household accessories
26	Avenue suites hotel	Hospitality service
27	Patmat bookshop	School accessories
28	Majid trading ltd	Household accessories
29	Nakuru wool shop	Clothing
30	Optica ltd	Eye clinic
31	Al-hagid shop	Electronics
32	Transwide phamaceuticals	Selling drugs
33	Glamshine beauty shop	Ladies makeups
34	Kiddys baby parlour	Babys' accessories
35	Lam's business	Selling Cloths
36	Maya emporium	Selling Cloths
37	Shikanisha enterprise ltd	Household goods
38	Emerging computers	Selling electronics
39	Prime mattress	Selling mattresses and beddings

40	Metropolitician sacco	Financial services
41	Office one print	Printing services
42	Ken photo studio	Photo shop
43	Hi-tech opticals	Eye clinic
44	Nakuru cosmetics	Beauty shop
45	Baruku shoe traders	Selling shoes
46	Elim central pharmacy	Selling drugs
47	Menengai agrovet	Selling farming products
48	Elim cosmetics	Beauty products
49	Nakuru afya chemist	Selling drugs
50	Late chemist	Selling drugs
51	Mainstreet coffee house	Selling food
52	Greenhouse hotel	Selling food
53	Synix samkam electronics	Selling electronics
54	Totos baby shop	Kids' accessories
55	Favourite scents cosmetics	Ladies beauty products
56	Prime motors	Selling cars
57	For-you house of fashions	Selling cloths
58	Oilibya	Petrol station
59	Victory trading company	Selling household products
60	Diva's collections	Selling cloths
61	Sakinya motors	Selling cars
62	Rift cars	Selling cars
63	Canaan restaurant	Selling food
64	Kobil petro	Petrol station
65	Seguton pharmacy	Selling drugs
66	Range chem pharmacy	Selling drugs
67	Rani's Fashion	Selling cloths
68	Dalysa motors	Selling cars
69	5star house of fashion	Household products
70	Generation tyres	Selling tyres
71	Express cyber	Internet services
72	Vision rubber stamps signs	Making and selling stamps
73	Stepup connections	Phones and mobile accessories
74	Mokonge shop	Phone and phone accessories
75	Judes curio shop	Curio shop
76	Blessed lily shoe shop	Curio shop
77	Rose stall	Phones and mpesa services
78	Tabbys' shoe parlour	Selling shoes
79	Bensela phones & accessories	Phone and phone accessories
80	Ledali investments	Household goods
81	Amani shop	Household goods

82	Amka electronics	Selling electronic products
83	Delight opticians	Eye clinic
84	Nairobi veteran center	Selling farming products
85	Metropolitan chemist	Selling drugs
86	Meems ltd	Hardware
87	Bestlady cosmetics	Selling beauty products
88	Pace connections ltd	Phones and accessories
89	Mongoose property care	House agency services
90	Canaan supermarket	Selling Household goods
91	Steel parlour	Manicure services
92	Maya cosmetics	Selling beauty products
93	Steel in butchery	Selling meat
94	Modern electricals	Selling electronics
95	Merica hotel	Food and accommodation
96	Family medicare	Selling drugs and clinical services
97	Samchi telecom	Phone and phone accessories
98	Vision Africa sacco	Financial services
99	Dimples hotel	Food and accommodation services
100	Tiles and homes appliances	Selling tiles
101	Happy go ltd	Phones and phone accessories
102	Ipiz restaurant	Food services
103	Flower bomb kinyozi	Barber shop
104	Baus opticals	Eye clinic
105	Dotina pharmaceuticals	Eye clinic
106	Farmer’s fresh market	Selling vegetables
107	Ashley events	Functions and Catering events
108	Goodwill wines and spirits	Selling drinks
109	Honesty bookshop	School accessories
110	Afoni clothings	Selling cloths
111	Danny’s mini market	Selling House items
112	Ck collections	House items
113	Splash center	lighting services
114	Imani foods	Hotel services
115	Xpekya collections	Selling house items
116	Glamour collections	Selling house items
117	Lilisam sport	Selling sporting items
118	Jn digital	Selling phones
119	Tabby’s beauty shop	Selling ladies items
120	Cape wine	Selling drinks
121	Takishi sport	Selling sport items
122	Virgy autoshop	Motorcycle spares
123	Digital saloon	Saloon services

124	Madingu traders	Household items
125	Muhoro printing center	Printing services
126	Maxxis café	Hotel services
127	Rihab business center	House hold items
128	Double N barber shop	Barber shop
129	Tropical business shop	Household items
130	Nakuru carpet center	Selling carpets
131	Mercy home fashions	Household items
132	Betrap enterprise	Household items
133	Ma Tony shop	Household items
134	Java house	Hotel services
135	Polo center	Household items
136	Munchiz business collections	Household items
137	Kokeb restaurant	Hotel services
138	Joje commercial agencies	Property management
139	Maigo hotel	Hotel and restaurant services
140	Nakuru afya chemist	Pharmaceutical services
141	Transwide properties	Property management
142	Ken’s mobile repair	Phone repairs
143	Marvo play station	Kids playing station
144	Integro wears	Selling of cloths
145	Jacknan cyber café	Internet services
146	Mariam’s salon	Saloon services
147	Mikeline ltd	Household items
148	Cakes by Sylivia	Food items
149	Bustani coffee house	Hotel services
150	Rift valley forex	Money exchange services
151	Joystep bookshop	School accessories
152	Mbogo GG & Co Advocate	Law firm
153	Baraka shoe traders	Selling shoes
154	Kenphoto studio	Photography
155	Shik park hotel	Hotel services
156	Lennz pizza joint	Hotel services
157	Koros lounge	Restaurant services
158	Valentine cake house	Hotel services
159	Unlisted enterprise	Household items
160	The fish box joint	Hotel services
161	German training institute	Training institute
162	Mpesa wabcom technology	Selling phones
163	Moka loca coffee & launge	Hotel services
164	Jimmyjey barbers & spa	Barber shop
165	The mobile store	Selling phones

166	Café lemon-tart	Hotel services
167	Kenjab motors	Selling cars
168	Xpress cyber	Internet services
169	Discover joy enterprises	Household items
170	Medipoint pharmaceuticals	Pharmaceutical services
171	New venus studio	Photography
172	Jydish collections	Household items
173	Nakuru tuishi	Household services
174	Flash cloud internet	Internet services
175	Egret consults inc	Consultancy services
176	Finix technologies ltd	Selling phone accessories
177	Browncord adverts	Advertising services
178	Prime baby shop	Selling kids accessories
179	Toplist computer solutions	Printing services
180	Graphic ink	Printing services
181	Nadmar dry cleaners	Cleaning services
182	Ian mbugua consultancy	I.T consultancy firm
183	Gai Gai Hardware	Buiding items
184	Konosi & company advocates	Law firm
185	Alpha executive ltd	Corporate training
186	Bliss tours & Travels agencies	Safaris, car hire, Air ticketing
187	Wameer wholesalers & distributors	Distribution services
188	Webnet technologies Nakuru	Internet services
189	Acrab internet	Internet service
190	Keicophine East Africa consultants	Consultancy services
191	Café Micasa Sucasa	Restaurant services
192	Mayscars Limited Studios	Photo and video editing services
193	Kenchip software systems	Internet services
194	VFRA	Consultant services
195	Amu Press LTD	Printing services
196	Damka properties	Real estate services
197	Evolution Computers	Selling computers
198	Zuca Solutions ltd	ICT solution provider
199	Kericho driving school	Driver training
200	Rift Events and Promotions	Event management services
201	Sheth & Wathigo Advocates	Law firm
202	Tint Kinyozi	Barber shop
203	Twinestar Commercial Agencies	Property management services
204	Rehome commercial Agencies	Property management services
205	Spanix technologies Ltd	IT services
206	Safetymed pharmacy	Pharmaceutical services
207	ClickAway Technologies	Internet and Printing Services

208	Nakuru Computers Resources	Selling computers
209	Pewa Communications LTD	Printing services
210	Marty Enterprises	House hold goods
211	Megalife Optometrist ltd	Eye care clinic
212	Beyond Encounters Tours and Safaris	Tour firm
213	Chip Intel Links	ICT services
214	Kentech cyber	Printing and computer services
215	Regent management	Property management
216	Rich Dad Stationeries	Printing services
217	Onetel Networks	Internet services
218	Rodi Orege & Co Advocates	Law firm
219	Joru Laboratories Suppliers ltd	Laboratory supplies
220	J P N Karara & Co	Auditing services

Appendix C: Research permit letter

REPUBLIC OF KENYA

NATIONAL COMMISSION FOR SCIENCE,TECHNOLOGY & INNOVATION

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This is to Certify that Mr.. VICTOR ACHOLA ADEMBA of Egerton University, has been licensed to conduct research in Nakuru on the topic: Effect of Capital structure on the profitability of micro and small enterprises: a case study of Nakuru central business district for the period ending : 24/December/2021.

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Appendix D: A Copy of Publication

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Research Article Open Access

Effect of Financing Structure on the Profitability of Micro and Small Enterprises in Nakuru Central Business District

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Abstract: Financing a business is among the steps towards achieving firm objectives. Having a proper financing structure is the key to the successful performance of an enterprise. Existing literature about financing structure and profitability of MSEs reveals contradicting results. This study sought to assess the effect of financing structure on the profitability of micro and small enterprises in Nakuru central business district (CBD). Specific objective was to establish the effect of retained earnings on the profitability of micro and small enterprises. The study adopted a descriptive survey research design. The target population was 1,249 MSEs located in the Central Business District. A systematic random sampling technique was used in the picking of the respondents; every K^{th} MSEs became part of the response group. Simple regression was applied in establishing the cause-effect of each of the independent variables to the dependent variable. The study revealed that there is a statistically significant relationship between the financing structure and profitability of MSEs. Retained earnings have a significant positive effect on profitability at a 5% level of significance. The study concluded that the financing structure significantly affects the profitability of micro and small enterprises in Nakuru central business district.

Keywords: Financing structure, Profitability, Micro and Small Enterprises.