

**INFLUENCE OF FINANCIAL STRUCTURE ON FINANCIAL PERFORMANCE OF
SMALL AND MEDIUM ENTERPRISES IN KISII CENTRAL SUB-COUNTY**

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DECLARATION AND APPROVAL

Declaration

This project is my original work and has never been presented for any academic award in any institution.

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MBA/2023/45669

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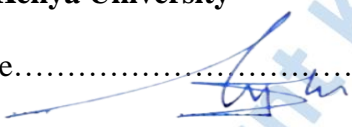
Approval

This thesis/project is being submitted for examination with our approval as University supervisors

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DEDICATION

This work is dedicated to my children Sandra Nyamisa and Lee Ratemo who may have contributed in one way or the other to my achievement so far



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The reality of this enormous task could not have been achieved were it not for the almighty God and a number of persons who I honour and respect. My most sincere gratitude first goes to my supervisor Dr. Kennedy Nyariki for his unquantifiable support and encouragement. Second is to all my other lecturers at Mount Kenya University for their value addition during the course. Last but not least is to my MBA colleagues who offered and continue offering their moral support through the journey.



ABSTRACT

The choice of financial structure and financial management has a greater effect on the financial performance of most firms in the world and in particular Kenya. While most firms try to find a solution to balancing both, financial structure choice and its impact on financial performance remains a greater dilemma to all small and medium enterprises in Kisii County. The study sought to investigate the influence of financial structure on financial performance of Small and Medium Enterprises in Kisii Central Sub-county, Kisii County. The study findings will be helpful to scholars, and policy makers and investors to make sound judgment when determining the financial structure to work with, for better financial performances. Findings from the study will be also be informative to researchers who may be interested in carrying out further studies on the relationship between financial structure and financial performance of small and medium enterprises. Pecking Order Theory, Agency Cost Theory and the Modigliani-Miller Theories were used in the study to provide explanations on the phenomena under study. This was a descriptive survey and questionnaires will be used in collecting data from the respondents. Random sampling was used as the general sampling technique with the aid of the Yamane's formula to select 109 SMEs to participate in the study from a target population of 150 SMEs in Kisii Central Sub-County. Statistical package for social sciences (SPSS version 23) was used to analyze both qualitative and quantitative data that was collected during the study. The study has indicated that a good number of respondents understands the concepts of equity capital and prefers it as a source of finance as it is not redeemable and it is permanent source of finance. The owner controls the business and enjoys profits whenever it's high and bears the risk alone. It does not entail any charge. This therefore shows equity capital forms higher proportion of financial structure hence has a significant effect on financial performance of SMEs. Debt capital has a negative effect on the performance of SMEs due to its fixed interest that must be paid where the firm makes profit or not. The study concludes that, firms with good asset base attracts lending financial institutions hence boosting their performance as they are able to face challenges that are in business cycles. From the study retaining earnings was well appreciated irrespective of not having a significant effect on financial performance due to challenges of raising it. It stands a chance of being the best source of finance for expansion because it is the cheapest and painless method of raising additional capital. The study recommendations to various stakeholders which include management, lending institutions, government and researchers. Management of SMEs should ensure that the financial structure of the firm is always at optimum. The firm cannot only survive on equity capital due to its low risk, also cannot wholly depend on debts due to high risk, more so retained earnings is only realized after making profit.

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LIST OF ABBREVIATIONS AND ACRONYMS

GOK-Government of Kenya

SMEs-Small and Medium Enterprises

SPSS-Statistical Package for Social Sciences

CEO-Chief Executive Officer

NSE-Nigerian Stock Exchange

NSE-Nairobi Securities Exchange

ROA- Return on Assets

GP-Gross Profit

NP- Net Profit

ROE- Return on Equity

EPS-Earnings per share



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CHAPTER ONE

INTRODUCTION

1.0 Background to the study

Large firms in the world have been receptive to the advancements made in modern financial theory and the increasing globalization of markets. Corporations are already used to making decisions with regards to operating environment, corporate objectives, financial reporting objectives, and agency costs as well as smaller firms. They have therefore recognized the advantages to be gained from the new advancements on knowledge and are eager to adapt new techniques for their benefit (Lindbergh, 2013).

The determination of a firm's optimal financial structure is a difficult task since it involves an analysis of several factors, key among them risk and profitability. The decision becomes even more difficult, in times when the economic, social, technological and political environment in which the firm operates exhibits a high degree of instability. Therefore, the choice among ideal proportion of debt and equity can affect the value of the company, as well as financial performance (Mwangi, 2023).

Despite the role played by SMEs, one of the major causes of SMES failure is their limitation to financial access. Business organizations aim to improve on their production and operations efficiency and to increase their profit margin. Financial structure is one of the factors that may influence the efficiency and effectiveness of business operations. The capital structure of a firm is a mix of debt and equity that a firm uses to finance their business. Finance managers are therefore concerned with a financial structure that increases the profit margin at low cost (Njagi, Maina, & Kariuki, 2023).

But factors contributing to business failure can be addressed through proper strategies to drive growth and achievement of organizational goals. It is necessary and sufficient that proper care and attention be given while making financial structure decision option otherwise that can cause financial distress. Options could be several but to decide on the best in a firm's interest, a particular scenario needs someone to have a deeper understanding in the field of finance and to critically analyze the impact of the available options on the firm's performance (Mwangi, 2023).

The role played by Small and Medium Enterprises (SMEs) to the economy of most developing countries has become increasingly important as most consumers prefer personalized products and services; hence this has created inherent pressures towards making markets smaller. But the managerial costs of satisfying the demands of small markets are high as compared to big and generalized markets (Roshanak, 2013). Elsewhere the SMEs sector has increasingly been viewed as an important engine for job creation and economic growth.

Availability of finances has been viewed as an important factor for the financial performance of small and medium sized enterprises. Hence, limitation to finances hinders their growth and development (Levy, 2015)

Financial structure therefore represents the proportionate relationship between the different forms of long term and short term financing available to the SMEs. It may be simple to make the correct decision with regards to financing, but sometimes it requires time. Managers are always faced with a dilemma on whether to obtain finances from internal sources or go for external financiers that will include loans from financial institutions, trade credit, and issuance of equity shares. The creation of a capital structure in an organization influences the governance structure of that particular organization or firm, and in turn has direct impact on strategic decisions made by the managers (Njagi, Maina, & Kariuki, 2023).

Firms can generate funds to use either internally or externally. But when generating funds externally, most firms choose between equity and debt. Most of the effort of financial decision making process is based on the determination of the optimal capital structure of the firm in question. Therefore, capital structure decisions affect all businesses, but will always vary from one business to another depending on their financial requirements. At the end success will depend on the ability of the managers to effectively manage a firm's financial resources properly (Narayanan, 2008)

1.1 Statement of the problem

Increased rate at which SMEs are closing down as a result of poor financial performances, has raised a lot of questions to researchers and practitioners. This has been attributed to the form of capital structure employed by these small and medium enterprises (Birundu, 2015).

Despite the important role SMEs play in the Kenyan economy, Kenya's Sessional Paper No 2 of 2005 indicates that 3 out of 5 businesses fail within their first 3-5 years of operation (GoK, 2009). This leads to job loss and consequently increased insecurity, low liquidity in the economy and decline in economic growth. The financial reports issued by most firms provide an overview of the financial health of the organizations but this maybe false at times as they are prepared by inexperienced staff. In cases where they are trained, they as well perform numerous tasks.

Small and Medium Enterprises (SMEs) are critical drivers of economic development and growth in many countries, including Kenya. They contribute significantly to job creation, poverty reduction, and the overall economic development of both urban and rural areas. In Kenya, SMEs account for over 80% of the total private sector employment and a substantial portion of the national GDP (Republic of Kenya, 2020). Despite their potential, many SMEs face substantial

financial challenges that limit their ability to grow and maximize their performance. These challenges are often attributed to issues related to access to finance, ineffective financial management, and inadequate capital structures (Mwangi, 2018).

The financial structure of an enterprise refers to the mix of debt and equity used to finance its operations and growth. This financial structure plays a crucial role in determining the financial performance of a business, particularly for SMEs, which often operate with limited resources and capital. A well-structured financial setup can enhance liquidity, minimize risks, and increase profitability, while a poorly structured one can hinder growth, limit expansion, and even result in financial distress (Munyua, 2025). For SMEs in Kenya, understanding how different components of financial structure influence their financial performance is crucial for sustainability and growth in an increasingly competitive market environment.

Debt financing, which involves borrowing funds from external sources such as banks, microfinance institutions, or other lenders, is a common way for SMEs to raise capital for their operations. However, while debt financing can provide the necessary capital for expansion, excessive reliance on debt can increase financial risks, particularly in the face of fluctuating market conditions and interest rates. According to studies, the impact of debt financing on financial performance is a topic of debate, as while it can boost growth and profitability, it can also lead to financial distress if not managed properly (Gakure et al., 2018). For SMEs in Kisii Central Sub-County, understanding the balance between leveraging debt and maintaining financial stability is critical for long-term sustainability.

Retained earnings, another key component of the financial structure, represent profits that a business chooses not to distribute to shareholders as dividends, but instead reinvests in the

business. Retained earnings can be a crucial source of internal financing for SMEs, as they do not require external lenders or investors. However, the decision to retain earnings rather than distribute them can significantly affect a business's growth prospects. The effective use of retained earnings for reinvestment can improve liquidity and support business expansion. Studies have shown that SMEs that effectively utilize retained earnings for growth tend to experience better financial performance over time (Kiptugen, 2017). Understanding the role of retained earnings in SMEs' financial performance in Kisii Central Sub-County will shed light on whether businesses prioritize reinvestment in their operations or prefer external sources of financing.

Small and Medium Enterprises (SMEs) play a crucial role in the economic development of many nations, particularly in developing economies like Kenya. They are integral to job creation, poverty alleviation, and fostering innovation, contributing significantly to national GDP. However, despite their importance, SMEs in Kisii County, Kenya, like in many other regions, face numerous challenges in achieving optimal financial performance. These challenges often stem from limited access to capital, poor financial management practices, and an unstable economic environment.

The financial structure of an SME refers to the combination of debt, equity, and retained earnings used to finance its operations and growth. The choices SMEs make in terms of their financing sources can have a profound impact on their overall financial performance. Understanding the influence of these financing decisions on business performance is vital for enhancing the sustainability and competitiveness of SMEs in Kisii Central Sub-County, which has a growing number of businesses contributing to local employment and economic activities.

Debt financing, where SMEs borrow funds to finance their operations or expansion, has been a common source of capital for many businesses. However, excessive reliance on debt can result in high-interest expenses and financial distress, potentially impacting the profitability and long-term viability of an SME. On the other hand, debt can also serve as a tool for leveraging business growth, provided it is managed efficiently. This study seeks to explore the impact of debt financing on the financial performance of SMEs in Kisii Central Sub-County.

Retained earnings, the portion of profit not distributed to shareholders but reinvested in the business, is another significant component of an SME's financial structure. It allows businesses to reinvest in operations without incurring additional debt. The utilization of retained earnings can influence the liquidity, profitability, and sustainability of an SME. This study will also examine the influence of retained earnings on the financial performance of SMEs in Kisii Central Sub-County.

Furthermore, macroeconomic factors, such as the growth rate of the Gross Domestic Product (GDP), play a pivotal role in shaping the business environment. A rising GDP typically signals economic growth, which can lead to increased consumer demand, improved access to financing, and better business prospects. Conversely, a sluggish economy may result in reduced market opportunities and increased business risk. This study will investigate how the GDP growth rate impacts the financial performance of SMEs in Kisii Central Sub-County.

In light of these factors, this study aims to provide insights into how various elements of financial structure, such as debt financing, retained earnings, and macroeconomic conditions like GDP growth, affect the financial performance of SMEs in Kisii County. The findings of this

study could serve as a guide for SME owners, policymakers, and financial institutions to make informed decisions that could enhance the sustainability and profitability of SMEs in the region.

The economic environment, particularly the growth rate of the Gross Domestic Product (GDP), also plays a significant role in shaping the financial performance of SMEs. A growing GDP typically signals a favorable economic environment, which can lead to increased demand for goods and services, enhanced consumer spending, and improved access to finance. For SMEs in Kisii Central Sub-County, fluctuations in GDP growth can either stimulate business activity or hinder performance. Studies have demonstrated that SMEs are highly sensitive to macroeconomic changes, and factors such as GDP growth can directly impact their profitability and financial stability (Otieno, 2020). Thus, understanding the relationship between GDP growth and the financial performance of SMEs in Kisii Central Sub-County will provide insights into how broader economic factors influence the success of these enterprises.

The financial performance of SMEs is a key indicator of their sustainability, and it is influenced by the strategic decisions made regarding their financial structure. However, the factors that contribute to financial performance are multifaceted and can vary across different industries and geographical locations. In Kisii Central Sub-County, SMEs face unique challenges that are shaped by local economic conditions, access to capital, and the entrepreneurial environment. This study seeks to fill the knowledge gap by exploring how debt financing, retained earnings, and GDP growth rate influence the financial performance of SMEs in this region.

Most SMEs in Kenya and Kisii County are failing or have already stagnated even with the existence of various financing options in the country. This is maybe due to lack of knowledge on the best sources of finance for the SMEs. Other managers do not understand how financial

structure influences their financial performance. This can be attributed to lack of viable knowledge and solutions to the SMEs to understand the importance of financial structure in their long run performance and operations. Therefore, this study seeks to fill this gap and provide viable answers and ideas to SMES in Kisii Central Sub-county on how financial structure influences their financial performance and chances of survival in the current market.

1.2 Purpose of the study

The purpose of this study is to examine the influence of financial structure on the financial performance of Small and Medium Enterprises (SMEs) in Kisii County, Kenya, with a focus on Kisii Central Sub-County. Financial structure, which encompasses the mix of debt financing, retained earnings, and external macroeconomic factors like GDP growth, plays a critical role in determining the financial stability and performance of SMEs. Despite the growing importance of SMEs in Kenya's economy, particularly in Kisii County, there is limited empirical research exploring how different components of financial structure impact the financial outcomes of these enterprises. This study seeks to address this gap by assessing the contributions of debt financing, retained earnings, and GDP growth rate on the overall financial performance of SMEs in the region.

The study will be useful to both the central government of Kenya and the Kisii County government as it will aid both governments in the creation of proper policies that will help streamline operations in the private sector and especially those that directly affect the SMEs.

It will also provide financial institutions that are keen to finance SMEs will knowledge and factors to consider when accessing the ability of an SME to remain financially sound for the period that they intend to finance such entities.

To the SMEs themselves, findings that will be shared with them will provide a basis for them to analyze their entities and factors that will in the long run affect the financial performance and profitability in general.

1.3 Objectives of the study

The main objective of this study will be to investigate the influence of financial structure on financial performance of Small and Medium Enterprises in Kenya, with a particular interest of the SMEs operating in Kisii Central Sub-County of Kisii County.

The specific objectives will be:

- 1) To establish the impact of debt financing on financial performance of small and medium Enterprises in Kisii Central Sub-County.
- 2) To establish the influence of retained earnings in financial performance of small and medium enterprises in Kisii Central Sub-County.
- 3) To establish the impact of GDP growth rate and financial performance of small and medium enterprises in Kisii Central Sub-County.

1.4 Research questions

- 1) How does debt financing affect the financial performance of small and medium enterprises in Kisii Central Sub-county?
- 2) What is the influence of retained earnings on the financial performance of small and medium enterprises in Kisii Central Sub-county?
- 3) How does GDP growth rate impact on the financial performance of small and medium enterprises in Kisii Central Sub-county?

1.5 Justification of the study

The financial structure of small and medium enterprises (SMEs) plays a critical role in their performance, sustainability, and growth, particularly in emerging economies like Kenya. In Kisii Central Sub-County, SMEs represent a substantial portion of the local economy, providing employment and contributing to income generation for many households. However, these businesses often struggle with securing adequate financing, which directly impacts their ability to operate efficiently and expand. Despite the importance of SMEs, there is limited empirical research on how different elements of financial structure—such as debt financing, retained earnings, and macroeconomic factors like GDP growth—affect their financial performance.

This study is, therefore, essential in filling the knowledge gap on the relationship between financial structure and the financial performance of SMEs in Kisii Central Sub-County. By focusing on the impact of debt financing, retained earnings, and GDP growth rate, this research will provide critical insights into how SMEs can improve their financial management practices to enhance their performance.

Debt financing is a common strategy used by SMEs to raise capital, but the decision to incur debt can have both positive and negative consequences on business performance. While debt can provide the necessary resources to fund growth and expansion, it may also increase the financial risk of the business, especially when returns are not sufficient to cover the interest and principal payments. This research will examine how the level of debt financing influences the profitability and liquidity of SMEs in Kisii Central Sub-County, thereby guiding business owners on optimal debt usage.

Retained earnings are another vital component of the financial structure, representing a source of internal financing that can be used for reinvestment into the business. The extent to which SMEs in Kisii Central Sub-County rely on retained earnings for reinvestment can affect their financial stability and growth prospects. This study will explore how the accumulation and effective utilization of retained earnings impact the financial performance of these businesses.

Furthermore, the study will investigate the relationship between macroeconomic factors, particularly GDP growth rate, and the financial performance of SMEs. Economic growth can influence the demand for goods and services, access to financing, and the overall business environment. Understanding how GDP growth affects SMEs' performance in Kisii Central Sub-County will help policymakers and business owners make informed decisions regarding business strategies and resource allocation.

The findings of this study will be significant for both SME owners and policymakers. For SMEs, the research will offer actionable recommendations on how to balance debt financing with retained earnings to enhance profitability and ensure long-term sustainability. For policymakers, the study will provide insights into the role of the macroeconomic environment in shaping the financial outcomes of SMEs, potentially guiding future policies aimed at improving the financing options and overall business environment for SMEs.

In conclusion, this study is justified because it will contribute valuable knowledge on the financial management practices of SMEs in Kisii Central Sub-County, which could be applicable to other regions in Kenya and similar developing economies. By understanding the financial structure factors that influence SME performance, this research will assist in fostering a more

robust and competitive SME sector, which is crucial for economic growth and development in Kenya.

1.6 Significance of the Study

The significance of this study lies in its potential to contribute valuable insights into the relationship between financial structure and financial performance of Small and Medium Enterprises (SMEs) in Kisii Central Sub-County, Kenya. SMEs are key drivers of economic growth, job creation, and innovation in the country. However, their financial performance remains a challenge due to issues related to financing and resource allocation. By examining the impact of various financial components such as debt financing, retained earnings, and macroeconomic factors like GDP growth rate, this study seeks to uncover factors that influence the performance of SMEs in the region.

First, understanding the role of debt financing in SME performance is crucial, as access to credit is often a major constraint for businesses in Kenya. The study will provide insights into whether debt financing enhances or hinders the profitability and sustainability of SMEs, thus informing policy makers and financial institutions on how to better support these businesses.

Second, the influence of retained earnings on financial performance is an area that requires further exploration, especially in SMEs where internal financing often plays a significant role in business expansion and stability. This study will highlight how retained earnings can impact the long-term viability and growth of SMEs, contributing to the strategic decisions of business owners and managers.

Lastly, investigating the impact of GDP growth rate on SMEs will provide a broader understanding of how macroeconomic factors affect the financial outcomes of these businesses. As economic conditions fluctuate, it is important for SMEs to understand the ways in which such factors influence their performance, enabling them to develop resilient strategies during economic downturns or periods of growth.

Overall, the findings of this study will offer valuable recommendations for policymakers, financial institutions, and SME owners, helping them optimize financial structures and enhance the performance of SMEs in Kisii Central Sub-County, thereby contributing to broader economic growth and development in Kenya.

1.7 Scope of the study

This study aims to explore the influence of financial structure on the financial performance of Small and Medium Enterprises (SMEs) in Kisii Central Sub-County, Kenya. Specifically, the scope of the study will focus on the relationship between various components of financial structure and the financial performance of these SMEs. The research will be confined to SMEs operating within Kisii Central Sub-County, providing insights into the local dynamics that shape business performance in this region.

The first objective of the study is to establish the impact of debt financing on the financial performance of SMEs in Kisii Central Sub-County. This will involve examining how debt levels, debt management strategies, and the cost of borrowing affect profitability, liquidity, and overall financial health of the SMEs.

The second objective seeks to understand the influence of retained earnings on the financial performance of SMEs in the same region. The focus will be on how SMEs utilize retained earnings for reinvestment, expansion, and sustaining operations, and how this impacts their long-term financial stability and growth.

The third objective of the study will investigate the impact of the Gross Domestic Product (GDP) growth rate on the financial performance of SMEs. The study will analyze how broader macroeconomic factors, such as GDP growth, influence the financial performance of SMEs, particularly in relation to market demand, revenue growth, and operational efficiency.

The study will be limited to SMEs in Kisii Central Sub-County, Kenya, and will consider data from both primary and secondary sources, including financial records from selected SMEs, interviews, and other relevant documents. This geographical focus ensures a localized analysis, while the time frame will cover the most recent financial years to capture current trends and conditions.

In summary, the study will offer a comprehensive analysis of how debt financing, retained earnings, and GDP growth influence the financial performance of SMEs in Kisii Central Sub-County, with the findings contributing to a better understanding of the factors shaping the financial success of SMEs in the region.

1.8 Limitations of the Study

This study on the influence of financial structure on the financial performance of Small and Medium Enterprises (SMEs) in Kisii Central Sub-County, Kenya, acknowledges several limitations that may affect the generalizability and accuracy of the findings.

The study focuses specifically on SMEs within Kisii Central Sub-County, which may not fully represent the broader SME landscape across other counties or regions in Kenya. The small sample size and geographic scope limit the ability to generalize the findings to all SMEs in Kenya, as variations in financial practices and performance may exist in different regions or sectors.

The research depends on the availability and reliability of financial data provided by SMEs. Some SMEs may lack accurate, up-to-date financial records or may be reluctant to share sensitive financial information, which could introduce bias or errors in the data collection process. Furthermore, the reliance on self-reported data from SME owners or managers might result in responses influenced by personal or business biases.

Financial performance is influenced by multiple factors, and measuring it can be subjective depending on the chosen indicators (e.g., profitability, return on assets, or liquidity). Different SMEs may prioritize varying aspects of financial performance, which could result in inconsistencies when comparing results across the sample.

The study includes an analysis of the GDP growth rate and its impact on financial performance. However, the economic environment, including macroeconomic factors such as inflation, political stability, and government policies, may also affect SMEs in ways that are outside the scope of this research. The study cannot account for all external variables that might influence financial outcomes.

Due to time limitations, the research will capture only a snapshot of the SMEs' financial performance over a specific period. Long-term trends and cyclical patterns in financial

performance may not be fully reflected, which limits the depth of the analysis in understanding the long-term effects of financial structure.

The diverse management practices and operational strategies among SMEs may influence the financial performance, making it difficult to isolate the exact effect of debt financing, retained earnings, and GDP growth rate. SMEs in the sample may exhibit different levels of financial literacy, which could impact the interpretation of the relationship between financial structure and performance.

In conclusion, while this study aims to provide valuable insights into the financial structure-performance relationship within SMEs in Kisii Central Sub-County, these limitations must be considered when interpreting the findings and making generalizations beyond the scope of this research. Future studies could explore a larger, more diverse sample of SMEs and account for broader economic factors to enhance the understanding of financial performance in the SME sector.

1.9 Operational definition of key terms

In the context of the proposed study on the **influence of financial structure on the financial performance of Small and Medium Enterprises (SMEs) in Kenya**, the following operational definitions of key terms are provided:

1. **Debt Financing:** Debt financing refers to the process through which SMEs obtain capital through borrowing from external sources such as banks, financial institutions, or through the issuance of bonds. In this study, debt financing will be measured by the ratio of the enterprise's total debt to its equity, commonly known as the debt-to-equity ratio. The

impact of debt financing on financial performance will be assessed by analyzing the relationship between this ratio and key performance indicators such as profitability, liquidity, and return on assets (ROA).

2. **Retained Earnings:** Retained earnings refer to the portion of net income that SMEs choose to reinvest in the business rather than distribute to shareholders as dividends. It represents the cumulative amount of profit retained by the business over time. For the purposes of this study, retained earnings will be quantified by the ratio of retained earnings to total equity. The influence of retained earnings on financial performance will be measured by examining their impact on profitability, operational efficiency, and growth potential of SMEs.
3. **Gross Domestic Product (GDP) Growth Rate:** The GDP growth rate represents the annual percentage increase in the total value of goods and services produced within a country, adjusted for inflation. In the context of SMEs, this term will be operationalized by the annual percentage growth in Kenya's GDP, as reported by the relevant government or financial institutions. The influence of GDP growth rate on financial performance will be measured by analyzing how changes in the broader economic environment, as indicated by GDP growth, affect the financial outcomes of SMEs, including sales growth, profitability, and financial stability.
4. **Financial Performance:** Financial performance in this study refers to the measurement of an SME's ability to generate profit and create value. It will be operationalized using various financial ratios and indicators, including profitability (net profit margin), liquidity (current ratio), and return on assets (ROA). These financial indicators will be used to assess how well SMEs manage their resources, particularly in relation to their financial

structure (debt financing, retained earnings, and macroeconomic factors such as GDP growth).



CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

The chapter will present a review of the theoretical and empirical literature on the influence of financial structure on the financial performance of SMEs in Kisii Central Sub-County. This chapter will review financial structure theories, empirical reviews and determinants of financial performance. The conceptual framework will incorporate scholarly works and theories.

2.1 Empirical Literature

The section discusses studies that have been conducted locally and internationally which examined the influence of financial structure on financial performance of Small and Medium Enterprises.

2.1.1 Debt financing on financial performance of small and medium Enterprises

Small and Medium Enterprises (SMEs) play a critical role in the economic development of Kenya, contributing significantly to employment creation, poverty alleviation, and economic diversification. However, these enterprises often face challenges in accessing finance, which in turn affects their ability to grow and compete effectively in the market. One of the key sources of finance for SMEs is debt financing, which involves borrowing funds to be repaid with interest. The financial structure of an SME, particularly the use of debt, can significantly influence its financial performance.

The financial structure of Small and Medium Enterprises (SMEs) plays a crucial role in determining their financial performance. SMEs are significant contributors to economic development, especially in developing regions like Kisii County, Kenya. The financial structure

of an SME, which consists of the mix between debt and equity financing, influences the firm's capacity to operate effectively and expand in a competitive market. This literature review explores the influence of debt financing on the financial performance of SMEs, focusing specifically on the impact within Kisii Central Sub-County.

Debt financing refers to the practice of raising capital through borrowing, which can take various forms, such as loans, bonds, or credit lines. It is often used by SMEs to fund their operations, expansion, or working capital needs. While debt financing can provide businesses with the necessary capital to invest in their operations, its impact on financial performance is complex and multifaceted. Several studies have examined the relationship between debt financing and the financial performance of SMEs.

A common theory on debt financing is the **trade-off theory**, which suggests that there is an optimal level of debt financing that balances the tax benefits of debt with the costs of financial distress. According to this theory, SMEs can benefit from debt financing as it allows them to leverage their capital for growth without diluting ownership. However, the challenge lies in managing the risk of over-leveraging, which could lead to financial instability.

Studies by **Abor (2005)** and **Kessy & Luvanda (2012)** have shown that the use of debt financing can enhance the financial performance of SMEs by providing access to the capital necessary for growth and expansion. In their study of Ghanaian SMEs, **Abor** found a positive relationship between debt financing and return on assets (ROA), suggesting that appropriate use of debt can lead to higher profitability. Similarly, **Kessy & Luvanda** highlighted the positive role of debt in facilitating business operations and increasing the financial returns of SMEs in Tanzania.

However, the relationship between debt financing and financial performance is not always straightforward. **Modigliani and Miller's (1958)** capital structure theory posits that in perfect markets, the financial structure of a firm does not affect its overall performance. Nevertheless, in the real world, SMEs often operate in imperfect markets characterized by information asymmetry and market frictions. These challenges can make debt financing risky for SMEs, particularly when their capacity to generate stable cash flows is uncertain.

In Kisii County, the use of debt financing by SMEs is influenced by various challenges. **Mutuku (2014)** points out that access to credit in Kenya is often limited due to the high-risk perception of SMEs by financial institutions. SMEs are generally viewed as high-risk borrowers because of their small size, limited collateral, and often volatile cash flows. This results in higher interest rates, making debt more expensive and reducing its attractiveness as a financing option.

Mwangangi (2017) also highlights that SMEs in Kenya, particularly in rural areas like Kisii, face difficulties in accessing affordable debt due to the lack of financial literacy, which affects their ability to present robust business plans and financial statements to lenders. As a result, many SMEs resort to informal financing sources, such as family loans or local money lenders, which often come with higher interest rates and less favorable terms. This lack of access to formal debt financing can undermine the potential positive impacts of debt on the financial performance of SMEs.

Moreover, **Odera (2016)** observes that SMEs in Kenya often fail to effectively manage their debt, leading to problems such as over-leveraging and default. SMEs may take on excessive debt in the hope of expanding their business, but they may struggle to repay it due to insufficient revenue generation, leading to reduced profitability and financial distress.

The ability of SMEs to manage debt and associated risks is critical in determining the overall impact of debt financing on their financial performance. Research by **Oduor (2015)** and **Kamau (2018)** emphasizes the importance of financial management practices in SMEs. Proper debt management, including careful planning of repayment schedules and maintaining sufficient liquidity, can mitigate the negative effects of debt. SMEs that employ effective risk management practices are more likely to experience positive outcomes from debt financing, such as increased profitability and improved liquidity.

Furthermore, **Ngugi and Olweny (2013)** argue that SMEs that use debt strategically, for purposes such as capital investment in new products or expansion into new markets, are more likely to see improvements in their financial performance. However, debt used for short-term operational needs without a clear strategy can lead to poor financial outcomes.

Debt financing, when used optimally, can enhance the financial performance of SMEs by providing them with the necessary capital to expand their operations, invest in new technologies, or increase working capital. According to Modigliani and Miller (1958), debt financing can potentially increase a firm's value by leveraging its capital. This is based on the idea that debt, when used judiciously, can help SMEs generate higher returns on equity, leading to improved profitability. Debt financing is also associated with tax advantages, as interest payments on debt are tax-deductible, thereby reducing the overall tax burden of the business.

However, the impact of debt financing on the financial performance of SMEs is not always straightforward. While debt can stimulate growth, it also introduces financial risk. According to the trade-off theory, SMEs must balance the benefits of debt with the costs of financial distress, which increases as debt levels rise. High levels of debt increase the likelihood of default, which

could negatively impact the firm's profitability and long-term sustainability. Studies by Jensen and Meckling (1976) have suggested that excessive borrowing can lead to higher agency costs, especially when the interests of debt holders and equity holders diverge.

In the context of Kenya, SMEs often rely on short-term debt financing from financial institutions, microfinance institutions, and informal sources. A study by Kiptugen et al. (2014) found that access to credit and the cost of borrowing are key challenges faced by SMEs in Kenya. This is particularly true for SMEs in Kisii Central Sub-County, where limited financial literacy, lack of collateral, and stringent lending conditions often limit access to formal debt financing. As a result, many SMEs turn to informal sources of credit, which may not always offer favorable terms. The high interest rates and the risk of over-indebtedness associated with informal loans can have a negative impact on the financial health of SMEs, thereby hindering their financial performance.

Furthermore, the level of debt financing is also influenced by the owners' attitudes towards risk and their perception of the business environment. According to the pecking order theory, SMEs typically prefer internal financing, such as retained earnings, over external financing, such as debt, due to the costs and risks associated with borrowing. This theory suggests that SMEs will resort to debt only when internal resources are insufficient, and they will prefer less risky forms of financing.

Empirical studies on the impact of debt financing on the financial performance of SMEs in Kenya have produced mixed results. Some studies suggest that debt financing positively impacts financial performance by providing SMEs with the necessary resources for growth and expansion (Munyao & Makau, 2018). Others, however, indicate that excessive debt can lead to

financial instability, poor liquidity, and increased bankruptcy risk (Mutua & Memba, 2017). The varying findings highlight the importance of managing debt levels appropriately and considering the context-specific challenges and opportunities faced by SMEs in Kisii Central Sub-County.

In conclusion, while debt financing can have a positive impact on the financial performance of SMEs by enabling access to capital for growth and expansion, it also introduces financial risks that need to be carefully managed. SMEs in Kisii Central Sub-County face unique challenges in accessing formal debt financing, and their ability to leverage debt effectively depends on factors such as the business environment, the availability of collateral, and financial literacy. Further research is needed to understand the specific dynamics of debt financing in this region and its impact on the financial performance of SMEs. This study will aim to explore the relationship between debt financing and the financial performance of SMEs in Kisii Central Sub-County, providing insights that can help SMEs manage their financial structure more effectively.

2.1.2 Retained earnings in financial performance of small and medium enterprises

Financial performance is a critical measure of the success and sustainability of Small and Medium Enterprises (SMEs). Retained earnings, which refer to the portion of profit not distributed as dividends but reinvested in the business, are often considered a key determinant in assessing the financial health and performance of SMEs. Retained earnings provide businesses with a source of internal financing, which can be used for expansion, asset acquisition, and other strategic investments. This literature review explores the role of retained earnings in shaping the financial performance of SMEs in Kenya, drawing on both theoretical perspectives and empirical evidence.

Retained earnings serve as a crucial component of the capital structure of SMEs. Unlike debt, which requires regular repayments, retained earnings offer a more flexible source of funding for growth and operations. According to Titman, Keown, and Martin (2017), retained earnings are often viewed as a less risky source of financing because they do not increase the firm's financial obligations. For SMEs, especially in developing economies like Kenya, access to external financing is often limited due to challenges in credit markets and high borrowing costs. As such, retained earnings become an essential tool for financing without incurring debt or diluting ownership.

In the context of SMEs in Kenya, retained earnings have been shown to play a significant role in improving the financial stability of businesses. By retaining profits, SMEs can reduce their dependence on external sources of financing, which may not always be readily available. This aspect of financial self-sufficiency contributes to a firm's ability to weather economic downturns, invest in long-term growth, and enhance its competitive advantage (Mwangi & Mwangi, 2016).

The impact of retained earnings on profitability is widely acknowledged in the literature. Retained earnings, by financing investments in capital, technology, or human resources, can increase the productive capacity of an SME, which in turn, may boost its profitability. According to the pecking order theory proposed by Myers and Majluf (1984), firms with higher retained earnings are more likely to reinvest their profits into projects with positive net present value (NPV), thereby improving their financial performance over time. This is especially relevant for SMEs that may have limited access to equity markets or debt financing.

Empirical studies in Kenya indicate that SMEs that effectively manage and reinvest retained earnings experience higher growth and profitability. A study by Kinyanjui (2015) found that

SMEs that maintained higher levels of retained earnings showed better financial performance in terms of revenue generation and profit margins. This finding suggests that retained earnings enable businesses to fund growth opportunities without the need for external debt, which can enhance profitability by avoiding interest expenses and financial risk.

In addition to profitability, retained earnings can influence the liquidity position of SMEs. Liquidity refers to the ability of a business to meet its short-term obligations, and it is a critical aspect of financial performance. By retaining earnings, SMEs are able to build a reserve that can be used to cover working capital requirements, such as inventory and payables. This is particularly important for SMEs in Kenya, where access to trade credit and short-term loans can be constrained by the lack of collateral or credit history.

Studies have shown that firms with higher levels of retained earnings tend to have better liquidity, as they do not rely on short-term borrowings or external financing. A study by Owino and Mugenda (2018) on Kenyan SMEs revealed that firms with substantial retained earnings reported higher liquidity ratios, which allowed them to manage their operational needs more effectively. As a result, these firms were better

While retained earnings can positively influence the financial performance of SMEs, it is important to recognize that there are challenges and limitations associated with this financing strategy. One such challenge is the opportunity cost of retaining earnings rather than distributing them as dividends to shareholders. Retained earnings represent profits that could otherwise be shared with investors, and this trade-off may affect shareholder satisfaction or the firm's attractiveness to investors.

Moreover, the effective use of retained earnings requires sound management and investment decisions. SMEs in Kenya, particularly in the informal sector, may lack the financial literacy or expertise to allocate retained earnings efficiently. According to Gakure, Waweru, and Mwaura (2014), many Kenyan SMEs face difficulties in managing retained earnings, often using the funds for immediate consumption rather than long-term investments, which can undermine their financial performance.

The literature highlights that retained earnings play a crucial role in the financial performance of SMEs in Kenya. They provide a stable, internal source of financing that can support business growth, enhance profitability, and improve liquidity. However, the benefits of retained earnings are contingent on their effective management and allocation. SMEs that can strategically reinvest retained earnings into value-adding projects tend to perform better financially. The findings suggest that Kenyan SMEs should focus on improving their retention and utilization of earnings to strengthen their financial position, reduce reliance on external financing, and achieve sustainable growth.

2.1.3 GDP growth rate and financial performance of small and medium enterprises

Small and Medium Enterprises (SMEs) are critical to the economic growth of many developing nations, including Kenya. SMEs are recognized for their contributions to employment, poverty reduction, innovation, and overall economic development. However, despite their potential, SMEs often face significant challenges that hinder their growth, including poor access to finance, high operational costs, and limited managerial capacity. One of the key factors affecting the

growth and sustainability of SMEs is their financial structure, which refers to the mix of debt and equity financing used by a firm. The financial performance of SMEs is influenced by how effectively they manage their financial structure, which in turn is impacted by macroeconomic factors such as the Gross Domestic Product (GDP) growth rate.

This literature review examines the relationship between GDP growth rate and the financial performance of SMEs, focusing on how the broader economic environment affects SMEs' financial stability and profitability.

In many developing economies, including Kenya, SMEs play a vital role in driving economic development. According to the World Bank (2020), SMEs represent over 90% of all businesses and contribute significantly to employment and GDP in emerging markets. In Kenya, SMEs provide employment to approximately 80% of the workforce, contributing significantly to both the formal and informal sectors (Kenya National Bureau of Statistics, 2021). Despite this, SMEs face challenges such as inadequate access to finance, lack of skilled labor, and vulnerability to external shocks, including fluctuations in the national GDP.

The relationship between GDP growth and SMEs' financial performance is pivotal. GDP growth reflects the overall economic health of a country and impacts consumer demand, availability of credit, and overall business confidence. A strong, growing economy typically boosts the performance of SMEs by increasing consumer spending and improving access to financing.

The GDP growth rate is an important macroeconomic indicator that reflects the pace of economic activity in a country. It influences the financial performance of SMEs by affecting market conditions, investment climate, and credit availability. As the economy grows, businesses

experience increased demand for goods and services, which can lead to higher revenues, better profitability, and improved financial performance.

Numerous studies have explored the relationship between GDP growth and SME performance. For instance, Adebayo et al. (2018) observed that the growth of SMEs in Nigeria was closely linked to the rate of GDP growth. SMEs tended to perform better in periods of high economic growth, which provided a favorable environment for business expansion, increased investment, and improved market conditions. Similarly, in Kenya, SMEs are positively influenced by GDP growth as it increases consumer purchasing power and enhances business opportunities (Kinyanjui, 2025).

A growing economy typically encourages banks and financial institutions to provide more credit, especially in an environment where businesses show potential for growth and profitability. This is crucial for SMEs, as they are often undercapitalized and rely heavily on external financing. The expansion of credit availability during periods of GDP growth enhances SMEs' access to working capital, which is essential for expansion, purchasing raw materials, and meeting operational costs.

However, while GDP growth can stimulate SME growth, the relationship between GDP growth and financial performance is not always linear. During periods of high inflation, rapid economic growth may also lead to higher interest rates and increased operational costs for SMEs. According to a study by Mburu (2020), SMEs in Kenya were adversely affected by inflationary pressures during periods of economic growth, which eroded profit margins and strained financial resources. As a result, the impact of GDP growth on SME financial performance can be influenced by other macroeconomic factors, such as inflation, exchange rates, and fiscal policies.

Financial structure refers to the way a firm finances its operations, typically through a combination of debt and equity. The structure of financing adopted by SMEs significantly influences their financial performance. Debt financing involves borrowing funds, which can provide SMEs with the necessary capital to grow. However, too much debt can lead to high-interest expenses and potential liquidity challenges. On the other hand, equity financing, which involves raising capital from shareholders, does not require repayment but dilutes ownership.

A well-balanced financial structure allows SMEs to take advantage of both debt and equity financing to fund their growth without overburdening themselves with debt obligations. Studies have shown that SMEs with a strong financial structure—particularly those with access to affordable credit—tend to perform better financially, as they can capitalize on opportunities for expansion and innovation. According to Ojiako et al. (2021), SMEs in Kenya that maintain a balance between equity and debt financing generally report better profitability and lower risks of financial distress.

The influence of GDP growth on the financial structure of SMEs is significant. During periods of economic growth, SMEs may be more inclined to leverage debt due to the favorable economic conditions and increased access to credit. Conversely, during periods of economic downturn, SMEs might prefer to reduce their debt levels and rely more on equity financing to avoid the risks associated with high-interest rates and repayment pressures.

Despite the positive relationship between GDP growth and financial performance, SMEs in Kenya face several challenges in managing their financial structure. One of the primary challenges is the limited access to finance, particularly for SMEs in rural areas or those without established credit histories. According to the Central Bank of Kenya (2021), SMEs in Kenya face

high barriers to accessing affordable credit, and many financial institutions view them as high-risk borrowers.

Additionally, the lack of financial literacy among SME owners and managers further complicates financial management. Without a clear understanding of how to balance debt and equity, many SMEs in Kenya make poor financing decisions, which ultimately affects their financial performance. Training and capacity-building programs aimed at improving financial literacy and management skills could help mitigate these challenges and improve the financial outcomes of SMEs.

Moreover, SMEs are often exposed to economic risks, such as currency fluctuations and volatile interest rates, which can adversely affect their financial performance. For example, during periods of economic downturn, SMEs may struggle to service their debts or may face reduced demand for their products and services, negatively impacting profitability. This underscores the importance of adopting a flexible financial structure that can adapt to changing economic conditions.

The financial performance of SMEs is closely tied to the broader economic environment, and the growth rate of GDP is a key macroeconomic factor influencing this relationship. As the economy grows, SMEs benefit from increased demand, improved access to credit, and a more favorable business climate. However, challenges such as inflation, access to finance, and the financial management capabilities of SME owners must be addressed to ensure sustainable growth.

While GDP growth can stimulate SME performance, the effect of GDP on financial outcomes depends on the financial structure adopted by the firms. SMEs that maintain a balanced mix of

debt and equity financing are better positioned to leverage economic growth opportunities. Ultimately, improving financial literacy, access to credit, and the overall business environment will enable SMEs in Kenya to fully capitalize on the benefits of GDP growth and enhance their financial performance.

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

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

Birundu (2015) studied the effect of capital structure on the financial performance of small and medium enterprises in Kisii Sub-County, using a sample of 40 registered and operating SMEs in Kisii County. The findings indicated the relationship between, capital structure, debt and

financial performance of the firms. He concluded that although capital structure as a factor affects financial performance minimally, they should be factored any financial decisions that SMEs make.

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

According to a study conducted by (Hector, Elena, & Gonzalo, 2023), stated that financial structure of some firms in the city of Aguascalientes was consistent with the Agency theory that states the higher the external debt, the lower the financial performance of firms.

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

Njagi, Maina, & Kariuki (2023), in their study on equity financing and financial performance of SMEs in Embu town, they found out that equity financing has a positive relationship to the

financial performance of the SMEs in the region and therefore most of them do prefer sourcing for capital from friends rather than approach lending institutions. This was because the entrepreneurs prefer sharing risks with less risk averse investors at the same time avoiding any undesirable change in ownership.

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

Mwangi (2023), investigated the effect of financial structure on financial performance of firms listed at the East Africa Securities Exchanges, and stated that financial structure affects the financial performance of firms, though differently based on their capital source. Overall, he found out that there existed a strong effect of financial structure on both ROA and ROE. He also concluded that a huge proportion of asset financing could imply that short-term debt financing was less costly and therefore available compared to the long term debt financing which is usually associated with high value collateral and at times restrictive covenants hence making it unattractive.

Githire &Muturi (2015), in their study entitled effects of capital structure on financial performance of firms in Kenya, a case study of firms listed in the Nairobi Securities Exchange, concluded on the existence of overwhelming evidence that equity financing has a positive influence on a firm's financial performance. This was because of the direct control exercised by equity holders who ensure that resources allocated to the firms are appropriately utilized in ways that maximize shareholders' interests. Also, they indicated that long-time financing has a positive and significant effect on financial performance. This was evident by competitive

advantage when compared to large firms as well as in the development of credit management systems specifically suited for small firms so that they could access long-term financing

2.2 Theoretical Literature

Finance theories have made major advances in understanding the effect of capital structure on the financial performance of SMEs in the world. The following are some of the financial on the effect of capital structure on financial performance:

2.2.1 Agency Cost Theory

The theory is based on the behavioral relationship between the business owners and other business agents who the owners engage to perform particular tasks on behalf of the businesses. According to (Crutchley & Hansen, 2009) financing and corporate policy decisions can offer incentive to the various claimants that will minimize value-reducing behavior and hence reduce agency costs. They further state that the selection of management ownership, leverage, and dividends can mitigate agency costs arising from the firms. However (Jensen & Meckling , 2006), state that a firm's management can increase its share of ownership in their particular firm and align its interests with those of shareholders, and hence results in a convergence of interests between the shareholders and the managers. This will therefore reduce agency costs as managers are motivated to follow value-maximizing options. But with an increase in their equity share in their firms, management reduces the diversification of personal portfolio.

Alternatively, with a reliance on debt financing, a firm can reduce its agency costs. This will reduce the need for equity financing and avoid the associated agency costs.

2.2.2 Pecking Order Theory

As advanced by (Myers, 1984), the theory states that firms prefer internal sources of financing as they adapt their dividend payout ratios to investment opportunities. Companies prioritize their sources of financing from internal financing to equity according to the law of least effort, or of least resistance, preferring to raise equity as a financing means (Birundu, 2015).

Therefore, when internal financing is depleted, then debt is issued, and when no more debt can be issued, equity comes into play. According to the theory, businesses adhere to the hierarchy of financing whereby they first prefer internal financing, followed by debt when external financing is required.

Myers (1984) further argues that equity is the least preferred means to raise capital structure by businesses because as managers issue new equity, most investors tend to believe that the managers think their firm is overvalued and managers are sort of taking advantage of the situation. Therefore, they place a lower valuation of the equity issuance.

2.2.3 Modigliani-Miller Theory

The Modigliani –Miller theorem (of Franco Modigliani, Merton Miller) was first developed in 1958 by economists Franco Modigliani and Merton Miller and it forms the basis for modern thinking on capital structure in particular for small and medium enterprises. They state that under a certain market price process, and in the absence of taxes, bankruptcy costs, and asymmetric information, the value of a firm is unaffected by how its operations are financed. It does not matter if the firm's capital is raised through the issuance of stock or selling debt, neither does it matter what the firm's dividend policy is. Hence this theory is also referred to as the capital irrelevance principle.

Therefore, debt is a preferable source of financing for less taxation is laid on debt. It therefore acknowledges that if capital structure is optimal at 100% debt financing, it will minimize the weighted average cost of capital and maximize firm performance. However, the theory also states that there is a positive relationship between a firm's leverage and its performance (Modigliani & Miller , 1958).

2.3 Conceptual Framework

After the careful study of literature, the below conceptual framework has been formulated to illustrate the relationship that exists between financial structure and financial performance.

Independent Variables

Dependent Variable

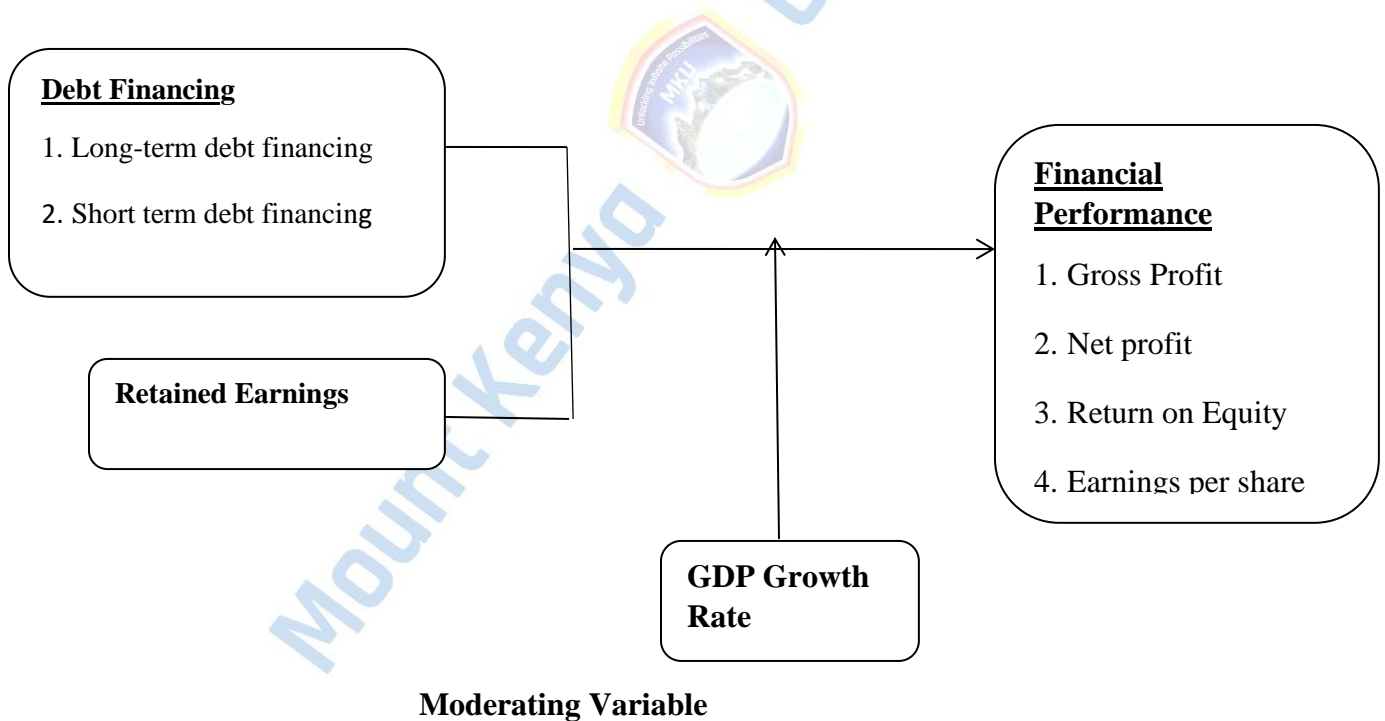


Figure 1: Conceptual Framework

Source: Author, 2023

In most organization, particularly SMEs retained earnings and debt ration play a significant role in shaping the enterprises financial structure. And based on the financial structure that the enterprises prefer to operate with, it will also direct influence its financial performance. Hence this is reflected in the enterprises gross profit, net profit, return on equity and earnings per share as per the above conceptual framework diagram.

2.4 Research Gaps

The financial structure of Small and Medium Enterprises (SMEs) plays a crucial role in determining their ability to thrive in a competitive environment. For SMEs in Kenya, a strong financial structure is pivotal for long-term growth, sustainability, and the achievement of desired financial performance. While the financial structure is recognized as an important determinant of financial performance, there remains a significant gap in research on how financial structure interacts with other macroeconomic variables, particularly the Gross Domestic Product (GDP) growth rate, to influence the financial performance of SMEs in Kenya.

SMEs, often described as the backbone of many economies, contribute substantially to employment, innovation, and the overall economic development of a country. However, despite their significant contribution, SMEs in Kenya face persistent challenges in accessing financing, managing capital, and adopting efficient financial structures that can enhance their financial performance. Financial performance in this context refers to profitability, liquidity, solvency, and overall economic viability, which are directly influenced by the financial structure choices made by SMEs. These choices—ranging from debt to equity ratio, capital investment, and working capital management—affect how SMEs navigate economic shocks, growth opportunities, and changing market dynamics.

Although much research has been conducted globally regarding the relationship between financial structure and the performance of SMEs, most of these studies tend to focus on more developed economies or have limited empirical analysis specific to developing countries like Kenya. For instance, scholars like Rajan and Zingales (1995) highlight that financial structure influences the performance of firms, but their study predominantly concentrates on developed markets where financial systems are more mature and access to capital is generally easier. This leaves a knowledge gap when it comes to understanding how the financial structures of SMEs in developing countries, particularly in sub-Saharan Africa, respond to varying levels of economic growth as measured by GDP growth rates.

In Kenya, the economy has experienced fluctuating growth rates due to factors such as political instability, macroeconomic policies, and global economic shifts. However, there is limited scholarly work that links how these growth rate fluctuations impact the financial performance of SMEs, particularly when considering their internal financial structures. Specifically, SMEs in Kenya face challenges related to capital structure decisions, access to affordable credit, and the availability of financial resources for expansion or innovation. Therefore, the interaction between GDP growth rate and SME financial performance, in the context of their financial structure, remains poorly understood.

Further compounding the research gap is the insufficient exploration of how external economic factors, such as GDP growth rate, affect the financial decisions of SMEs in Kenya. Economic growth, as indicated by the GDP growth rate, influences demand for goods and services, market competition, and access to capital. For instance, periods of high GDP growth may present an environment conducive for SMEs to expand their operations, increase production, and tap into

new markets. Conversely, during periods of economic downturn, SMEs may face liquidity challenges, reduced consumer spending, and increasing difficulty in managing debt. The financial structure of SMEs, characterized by the mix of debt and equity financing, will determine how resilient a firm is in navigating such economic cycles.

However, existing studies fail to adequately examine how GDP growth rate affects the way SMEs in Kenya structure their finances. For example, does a high GDP growth rate encourage SMEs to leverage more debt to expand, or do they prefer equity financing to mitigate risks? Alternatively, during periods of slow economic growth, do SMEs scale back their debt financing to avoid liquidity problems, or do they adopt different financial strategies to stay competitive? These questions remain unanswered in the current literature, thus creating an important research gap.

Moreover, previous research on SME financial performance tends to focus on isolated variables such as internal financial management practices or capital structure, without considering the broader economic context. It is clear that macroeconomic factors like GDP growth rate play a significant role in shaping the performance outcomes of SMEs, but how these factors influence financial decisions and ultimately, financial performance, has yet to be fully explored.

The gap in literature surrounding the impact of GDP growth rate on SME financial performance is particularly critical for policy makers and business leaders. Understanding the interaction between these factors is essential for crafting policies that support the sustainability and growth of SMEs in Kenya. The financial structure decisions made by SMEs are often influenced by macroeconomic conditions. A stable or growing economy with a positive GDP growth rate provides a favorable environment for SMEs to thrive by offering greater access to markets and

resources. However, when the GDP growth rate stagnates or declines, SMEs are faced with numerous challenges, including increased cost of capital, reduced consumer demand, and limited access to financing.

This research gap is significant because it has direct implications for how SMEs in Kenya can better prepare themselves for fluctuations in the economic environment. SMEs may need to adjust their financial structure to align with the changing economic conditions, particularly in response to shifts in GDP growth rate. Understanding the relationship between these variables will empower SMEs to make informed financial decisions, reduce risk, and enhance their ability to withstand external economic pressures.

In conclusion, while substantial research has been conducted on financial structure and its influence on the financial performance of SMEs, there is still a notable lack of studies examining the role of macroeconomic variables such as the GDP growth rate in shaping this relationship. Specifically, in the Kenyan context, the interplay between GDP growth and the financial performance of SMEs remains underexplored. This gap presents a valuable opportunity for research that will not only contribute to the academic literature but also offer practical insights for SMEs, policymakers, and financial institutions in Kenya. Addressing this research gap is crucial for understanding the broader economic dynamics that influence the financial performance of SMEs and will provide a foundation for future studies that investigate how SMEs can better navigate economic changes through sound financial structuring.

By focusing on the relationship between GDP growth and financial performance, this research will contribute to a deeper understanding of the financial strategies employed by SMEs in Kenya

and provide guidance for improving their economic resilience and sustainability in an ever-changing macroeconomic environment.



CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter describes the techniques and procedures that will be used in conducting the study. It comprises of the description of the study population, sampling methods and sample size, data collection methods and data analysis methods.

3.1 Research Design

The study will adopt a descriptive survey design. This research design suits the research study as it will allow for an in-depth study on how financial structure influences the financial performance of SMEs in Kisii Central Sub-County.

According to Orodho (2003), a descriptive survey design involves the collection of information by interviewing or administering a research questionnaire to a sample of individuals. The case study will therefore provide the researcher with in-depth information, which will assist answering the research questions.

3.2 Location of the study

In the proposed study titled *"Influence of Financial Structure on Financial Performance of Small and Medium Enterprises in Kisii County, Kenya,"* the research will be conducted in Kisii County, which is located in the Nyanza region of western Kenya. Kisii County, with its vibrant economy and numerous small and medium enterprises (SMEs), offers a representative setting for investigating how financial structure influences business performance.

Kisii County has a well-established base of SMEs across various sectors, including agriculture, trade, manufacturing, and services. These enterprises are crucial for the local economy, offering

employment opportunities and contributing to regional development. Despite the critical role SMEs play in the economic growth of Kisii, challenges such as limited access to finance, poor financial management, and insufficient knowledge of financial structures often hinder their optimal performance.

This study will focus on SMEs located in urban centers such as Kisii Town, as well as rural areas within the county. These areas are home to diverse businesses of varying sizes, providing a broad spectrum of data regarding financial structures and performance. By selecting Kisii County as the study location, the research aims to offer valuable insights into the relationship between financial structure and performance, which can inform policy development and assist local business owners in enhancing their financial management practices.

The choice of Kisii County as the study location is also based on the relative scarcity of comprehensive research specifically addressing SMEs in this region. This gap presents an opportunity to contribute to the academic literature on the financial dynamics of SMEs within Kenya's broader economic context.

3.3 Target Population

The study's target population will be all the SMEs operating within Kisii Central Sub-County. The study will conduct a census to come up with a list of 150 SMEs that are listed under this geographic location. From this population, 109 SMEs will be randomly selected to participate in the study.

3.4 Sampling Procedures and Techniques

According to Lavrakas(2008), a sample in a research study is a subset of elements drawn from a larger population. First all SMEs in the study location will be listed through a census exercise to obtain information regarding their location and contact information.

Random sampling will be used to sample 109SMEs in Kisii County that will participate in the study. Those who will be randomly selected into the sample will be interviewed as they will be in a position to provide relevant information with regards to financial management of the organizations they represent.

3.5 Sample Population

According to (Cooper & Schindler, 2008), the smaller size of a population is called the sample size. Therefore, the study will adopt Yamane’s formula to be able to obtain a relative sample size of 109 SMEs for the study as follows:

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

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

Therefore:

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

$$n = 109$$

3.6 Construction of Research Instruments

The study will use questionnaires and key informant interviews to collect data from the selected sample. This will be constructed in consultation with the supervisor to make sure that the tools will capture all the relevant needed information.

3.7 Testing for validity and reliability

Pilot studies will be conducted involving two respondents to establish the reliability and validity of the study instruments. For reliability of the tools, the test-retest will be used and for validity, the researcher will use face and content validity to test the tools. In face test, the researcher will basically examine the questionnaire questions in light of what information or data he will be looking for and who will be interviewed while in content validity researcher will look to see if the questions will actually capture all aspects of what is being captured.

Any adjustments will be done using the result of the pilot study to enhance validity and reliability of the tools.

3.8 Data collection Methods and Procedures

Primary data will be collected through the administration of research questionnaire. After sampling, they will be dropped at the various sampled SMEs in Kisii Central Sub-County and collected after two days to allow the respondents to fill them.

The questionnaires will comprise of both open and closed ended questions. The study questionnaire will comprise of three sections: The factors that influence the establishment of the financial structure of the SMEs; how long term-long and short-term financing affects the financial performance of the SMEs.

3.9 Data Analysis Techniques and Procedures

According to Gray (2004), a codebook is a set of rules for the assigning of numerical values to answers obtained from research respondents. Data that will be collected will be coded before being entered into the computer for data analysis. The data will also be cleaned to ensure for

completeness of the information obtained. This data will be analyzed through the aid of SPSS version 23.

Since the study will employ both descriptive analysis and inferential statistics, the raw data will be presented in form of tables, charts with frequency distributions and percentages, which will be vital in making sense of the data.

3.10 Ethical Considerations

1. Introduction to Ethical Considerations

Ethical considerations are essential in ensuring that research is conducted with integrity, transparency, and respect for participants. The research proposal on the "Influence of Financial Structure on Financial Performance of Small and Medium Enterprises in Kenya" seeks to explore how the financial structure of SMEs impacts their financial performance, with a focus on the relationship between GDP growth rate and SME performance. Given the nature of the study, which involves collecting data from businesses, financial institutions, and economic indicators, several ethical principles must be carefully considered. These considerations include informed consent, confidentiality, anonymity, data integrity, and minimizing harm to participants. This section will address these ethical issues in the context of the research objectives and methodology.

2. Informed Consent

One of the fundamental ethical principles in research involving human participants is obtaining informed consent. In this study, the participants will include business owners, managers, financial officers, and possibly employees of SMEs. In order to comply with ethical standards,

the researcher must ensure that all participants are fully aware of the nature, purpose, and scope of the study before their involvement.

Before any data collection, all participants will be informed about the objectives of the study, the voluntary nature of their participation, and their right to withdraw at any stage without penalty. Informed consent will be obtained through written consent forms, where participants will acknowledge their understanding of the study's purpose and their voluntary participation. The consent forms will clearly outline the procedures involved, the potential risks (if any), and the intended use of the data, including how it will contribute to the study's overall goals.

The researcher will emphasize that participants' involvement will not require them to disclose any confidential or sensitive business information unless they choose to do so willingly. Participants will also be informed about their right to remain anonymous, and they will be reassured that their responses will not affect their business operations.

3. Confidentiality and Anonymity

Confidentiality is crucial in ensuring that participants feel secure in providing honest and accurate information without fear of exposure or misuse. Since this study will involve financial data and insights from SMEs, which may be sensitive, maintaining confidentiality will be paramount.

The researcher will take steps to safeguard the data and ensure that it is only accessible to authorized individuals involved in the analysis. All data will be stored in secure, password-protected files, and any identifying information will be kept separate from the data set. Identifiers such as business names, owners, and other potentially identifying details will be replaced with

codes to ensure anonymity. The researcher will ensure that no participant's data can be traced back to them in any reports or publications arising from the study.

Moreover, any publication or dissemination of the research findings will present data in aggregate form, ensuring that no individual SME's financial performance can be identified. If any participant requests to review or access their data, they will be granted permission, as long as it does not compromise the integrity or confidentiality of the study.

4. Protection from Harm

Another critical ethical principle in research is minimizing harm to participants. In this study, potential risks to participants are minimal. However, since the research will involve questions related to financial performance and business growth, there is a need to ensure that the participants do not feel their financial status is being scrutinized in a way that could harm their reputation or business operations.

The researcher will be cautious when framing questions to avoid causing embarrassment or discomfort to participants. Participants will be informed that the study focuses on understanding general trends and patterns rather than judging or criticizing individual financial decisions. The researcher will also take steps to ensure that the data collection process does not interfere with the normal operations of the businesses involved.

Additionally, the researcher will make it clear to the participants that there will be no direct financial benefit or compensation for participating in the study. This is important to avoid any undue influence or bias in the data collection process. The researcher will also be mindful of not exploiting the SMEs' involvement for personal gain.

5. Data Integrity and Accuracy

The integrity and accuracy of the data collected are crucial to the credibility of the study's findings. As this research will involve collecting sensitive financial data from SMEs, the researcher must ensure that the data is accurate, reliable, and ethically obtained. The researcher will implement measures to cross-check data sources to avoid errors or misrepresentation.

To maintain data accuracy, all financial data from the SMEs will be obtained directly from the businesses or their official records, and any secondary data used, such as GDP growth rates, will be sourced from credible institutions like the Kenya National Bureau of Statistics (KNBS) or the World Bank. The researcher will carefully document the methodology used to collect and analyze the data to ensure transparency and allow for reproducibility in future research.

Moreover, the researcher will avoid any form of data manipulation or selective reporting that could skew the study's results. The research will adopt a strict adherence to the principles of honesty and transparency, ensuring that the findings are reported truthfully, even if they contradict the initial hypotheses or expectations.

6. Ethical Oversight and Accountability

Ethical oversight is essential in ensuring that the study adheres to accepted ethical guidelines throughout its implementation. The researcher will seek approval from an ethics review board or institutional review committee (IRC) before beginning the study. This step will help ensure that all ethical standards are met and that the research aligns with ethical guidelines set by academic and professional bodies.

Additionally, the researcher will maintain open communication with the SMEs involved, providing updates on the progress of the study and any changes in the methodology or approach.

If any unforeseen ethical issues arise during the study, the researcher will address them promptly, seeking guidance from relevant ethical review bodies if necessary.

The researcher will also provide participants with the results of the study if they request it, ensuring transparency and accountability in the research process.

7. Conflict of Interest

In conducting research, it is important to declare any potential conflicts of interest that could compromise the study's objectivity or integrity. The researcher will disclose any financial, personal, or professional relationships that might influence the outcomes of the study. If any conflicts of interest arise during the study, they will be promptly addressed, and measures will be taken to minimize their impact on the research process.

Additionally, the researcher will ensure that the research is conducted independently, without undue influence from any external parties, such as funding agencies or interested stakeholders, who may have a vested interest in the outcomes of the study.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.0. Introduction

This chapter presents the data analysis, presentations and interpretations of the findings on influence of Financial Structure on Financial Performance of Small and Medium Enterprises in Kisii Central Sub-County. Collected data is tabulated using tables and pie charts and then analyzed using descriptive statistics. The chapter captures study findings, analysis and results from data that has been collected by use of questionnaires. Descriptive statistics (means, standard deviation, variances, kurtosis and skewness) presented data in a manageable form so as to describe features of the collected data in the study. The chapter provides answers to the research questions and provides a basis for confirmation of relationships and conclusions.

4.1 Response Rate

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

4.2. General Information

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

4.2.1. Gender of the Respondents

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

4.2.2 Financial Advisory Services

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

4.2.3. Financial skills

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

Table 1: Financial management skills

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

Source: Survey Data, 2025

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

4.2.4. Profit Maximization

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

Table 2: Profit Maximization

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

Source: Survey Data, 2025

Table 4.3 study findings reveals that, majority (92.5%) of SMEs do make profits in their business activities. This has made them to remain in business. Most of SMEs have no any other source of income and depends on their business for their living. With 72 92.5% being able to make profit, this shows the reason why there has been tremendous growth of SMEs in Kisii County.

4.3 Optimal Financial Factors and Financial Performance

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

4.3.1. Sources Finances

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

Table 3: Source of finances

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

Source: Survey Data, 2025

Table 4.4 results above showed that, majority of the respondents got their equity capital from employment with a thirty-eight percent followed by farming with twenty six percent. The farming was anticipated by the researcher since Kisii is tea farming zone which is considered to be the best paying cash crop country wide. This indicates that, some SMEs were employed and either resigned or retrenched and the money earned during employment was used as capital to start the business. Others did some farming and were able to get a startup capital

4.3.2 Factors determining your firm's financial structure

Financial structure refers to the mix of debt and equity that a company uses to finance its operations. This composition directly affects the risk and value of the associated business. The study sought to establish the following factors determine financial structure of SMEs. A set of six items were used. The findings based on a Likert scale rating, where 1 was strongly not considered (SNC) and 5 was Strongly considered (SC) were summarized in Table 4.5 below.

Table 4: Factors determining your firm's financial structure

Factor	SC	C	N	NC	SNC	MEAN
Firm Assets	38.	24.6	30.	2.9	38.7	2.69
	7		3			
Firm Growth opportunities	53.	38.3	5.7	0.6	0	2.93
	3					
Trading on equity	28.	32.6	17.	16.	0	3.50
	4		9	9		
Debt and non-debt tax shields	28.	32.6	17.	16.	0	2.31
	4		9	9		
Financial flexibility	18.	17.9	21.	29.	10.5	2.69
	2		4	4		
Loan agreements	32.	18.8	25.	12.	8.3	2.98
	6		3	5		

Source: Survey Data, 2025

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

Hence, results in Table 4 indicate that most of the respondents were in agreement or neutral or disagreed to the selected items on financial structure.

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

4.3.3. Factors Influencing Optimal Financial Structure for privately owned SMEs

In this study, financial structure represents the proportion of debt capital and equity capital in the privately owned SMEs. The financial structure should be such which increases the value of the business entity and improve profits to the enterprise. As per the respondents, the following is the composition of the financial structure of SMEs;

4.4. Debt Financing

According to this study, debt capital refers to the amount of money that owner borrows and has to repay the principle amount plus the interest. It earns a fixed rate of interest which must be paid whether the business makes profit or loss. It can either be short-term or long-term. A lot of debts are dangerous to the business. The study found that majority of SMEs prefers short-term debts.

To establish the extent to which the SMEs appreciate the usage of debt capital, researcher sought to determine the impact of debt interest on the performance of the firm.

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

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

4.5 Retained Earnings

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

From the study the researcher established that, the SMEs understands and knows the factors and uses of retained earnings. This therefore enhanced the researcher's findings and interpretations.

Study findings reveal that retained earnings is the best source of finance which is ranked first

followed by equity capital. It is the cheapest source with very minimal risks; however the problem is how to raise it.

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

4.6 Discussions and Key Findings

The causal research design was applied as it involved collection, verification and synthesis of evidence that establishes facts that defended or refuted a hypothesis. The findings indicated a strong positive relationship of 0.683 between variables. Also revealed 45.4% financial structure of SMEs can be explained by independent variables.

The researcher used stratified sampling technique to reach at 28 SMEs. The study found that retained earnings were the cheapest source of finance. The study recommended that an entrepreneur should go for a capital mix that will give an optimum financial structure. No business small or large can operate with only one type of capital. Also more training to SMEs is needed to ensure proper utilization of available finance.

The study findings indicated a strong positive correlation ($R=0.683$) which is above the average 0.5. There was also a variation of 46.6% on financial performance of SMEs in Kisii Central Sub-County of Kisii County due to changes in equity capital, debt capital and retained earnings. The findings of the study indicated that, most of the SMEs (42.86%) stated their business with a

capital of around Kshs. 50,000 to Kshs 100,000. About 59.52% go for financial advice; this has made SMEs in Kisii Central Sub-County of Kisii County experience tremendous growth in recent years. The general statistics showed there was skewed distribution of the data used. On the preferred capital, equity capital proved to be preferred by many respondents (about 61.9%) as compared to debt capital, however many SMEs cannot afford enough equity capital and relies on debt capital. Githaiga (2015) states that, the abundance of loan facilities plus the demanding approval requirements of the scantily available equity fund have led many of the SMEs to resort to debt.

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

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

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

5.2 Summary

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

The study sought to investigate the effects of financial structure on financial performance of small and medium enterprises in Kisii Central Sub-County of Kisii County. The independent variables were Equity capital, Debt capital and Retained earnings while financial performance was the dependent variable. The study tested three null hypotheses that included; Equity capital

does not have significant effect, Debt capital does not have significant effect and Retained earnings do not have significant effect on financial performance of SMEs in Kisii Central Sub-County of Kisii County, Kenya. According to the study findings, equity capital and debt capital have significant effect while retained earnings don't have significant effect on financial performance of SMEs. This depends on how much each source represents in the financial structure. Each SME will have its own composition of the financial structure that ensures minimum weighted average of cost of capital.

The study was to establish the effect of equity capital on financial performance of SMEs in Kisii Central Sub-County of Kisii County. Equity capital is what the owner contributes to the business; it is permanent source of finance. Quite a number of SMEs appreciated the fact that equity capital is the best source of finance especially when one is starting the business. This is due to its low risk unlike debt capital that a business can suffer a lot in case of unforeseen eventuality that may lead closure. The study findings were clear that, no SME can raise enough equity capital hence there is need for other sources of finance.

Many small businesses raise their equity capital from personal savings and family support. The findings also revealed that equity holders are entitled to divide that keeps on varying depending on the business performance. The null hypothesis is therefore not true since the study have shown equity capital has a significant effect on financial performance of SMEs in Kisii Central Sub-County of Kisii County.

The study findings reveal was a significant effect on financial performance from debt capital. The researcher found that SMEs are aware of what is debt finance, is the money borrowed and repayable with an interest. Majority prefers a short-term loan which according to them has low risk and also lack collateral. There is need to have a good relationship with financial institutions

(banks) which must be maintained by adhering to the terms and conditions. The study found that equity capital is limited to sources but debt capital depended on assessment and judgment from the lending institution. Even though debt capital can be available anytime, the study found that one cannot borrow any amount since this can lead to liquidity problems due high gearing.

This therefore supports the alternative hypothesis that debt capital has a significant effect on financial performance of SMEs in Kisii Central Sub-County of Kisii County.

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

5.3 Conclusion

According to the study financial structure is an important factor on the financial performance of small and medium enterprise in Kisii Central Sub-County of Kisii County. The study has indicated that a good number of respondents understands the concepts of equity capital and

prefers it as a source of finance as it is not redeemable and it is permanent source of finance. The owner controls the business and enjoys profits whenever it's high and bears the risk alone. It does not entail any charge. This therefore shows equity capital forms higher proportion of financial structure hence has a significant effect on financial performance of SMEs.

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

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

5.4 Recommendations

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

On lending institutions, they will understand why despite the high number of SMEs in Kisii Central Sub-County of Kisii County not all are able to qualify for debt capital. They are limited by lack of collateral. The lending institution should develop structured ways of financing SMEs so as to boost their financial performance which may improve their lending business.

Lending institution need to develop products like asset financing that is tailor made to the SMEs. Also they should organize informative forums and seminars that will enhance their interactions with SMEs. Most of the SMEs have psychological fear against the financial institutions like banks and beliefs that, those are for big businesses. So it's high time the lending institutions make effort to breach the gap between them and SMEs.

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APPENDIXES

APPENDIX I: LETTER OF TRANSMITTAL

December, 2023

To the CEO, Manager, Administrator.....

Dear Sir/Madam

Re: Influence of financial structure on financial performance of Small and Medium Enterprises in Kisii Central Sub-county

I am a Master of Business Administration student at the Mount Kenya University conducting an academic research on the above subject. Managers, administrators and other management officials have been identified to participate in the study.

I am therefore requesting for your support in answering questions honestly and completely.

Please note that the information given will be treated with utmost confidentiality and under no circumstances will the information be used to fulfill selfish ends, including divulging it to any other parties without prior consent.

MBA/2023/45669

MOSES KIRIAGO RATEMO

**APPENDIX II: CONSENT FORM FOR PARTICIPATION IN RESEARCH
INFLUENCE OF FINANCIAL STRUCTURE ON FINANCIAL PERFORMANCE OF
SMALL AND MEDIUM ENTERPRISES IN KISII CENTRAL SUB-COUNTY**

Dear Participant,

I invite you to participate in a research study entitled **INFLUENCE OF FINANCIAL STRUCTURE ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KISII CENTRAL SUB-COUNTY**: I am currently enrolled in the master of business administration at Mount Kenya University and am in the process of writing my Master's project. The purpose of the research is to determine: Influence of financial structure on financial performance of small and medium enterprises in kisii central sub-county

- 1) The enclosed questionnaire has been designed to collect information on: How does debt financing affect the financial performance of small and medium enterprises in Kisii Central Sub-county?
- 2) What is the influence of retained earnings on the financial performance of small and medium enterprises in Kisii Central Sub-county?
- 3) How does GDP growth rate impact on the financial performance of small and medium enterprises in Kisii Central Sub-county?

Your participation in this research project is completely voluntary. You may decline altogether, or leave blank any questions you don't wish to answer. There are no known risks to participation beyond those encountered in everyday life. Your responses will remain confidential and anonymous. Data from this research will be kept under lock and key and reported only as a collective combined total. No one other than the researchers will know your individual answers to this questionnaire. There are no direct benefits to you for participating in this research. However, you may find it interesting to talk about the issues addressed in the research and it may be beneficial to the field and to future clients or individuals who have experienced similar concerns

If you agree to participate in this project, please answer the questions on the questionnaire as best you can. It should take approximately 5min to complete. Please return the questionnaire as soon as possible to enable me complete the project report.

If you have any questions about this project, feel free to contact *the INVESTIGATOR*, (*Put your own name in here, with contact information, and also the name of the person who will be supervising you, with his/her respective contact information*). If you have questions about your rights as a research participant, please be in touch with the Chairman, Mount Kenya University, Ethical Review Committee, P.O Box 342-01000, Kisii.

Thank you for your assistance in this important endeavor.

CONSENT

I have read and I understand the provided information and have had the opportunity to ask questions. I understand that my participation is voluntary and that I am free to withdraw at any time, without giving a reason and without cost. I understand that I will be given a copy of this consent form. I voluntarily agree to take part in this study.

Participant's signature _____ Date _____

Investigator's signature _____ Date _____

APPENDIX III: STUDY QUESTIONNAIRE

Influence of Financial Structure on Financial Performance of SMEs In Kisii central Sub-county

(Please tick the appropriate responses, where explanation is requested, be concise)

Section A: Employee and Firm Background Information

1. Kindly indicate your gender?

Male

Female

2. What is your age bracket?

a) 18 – 20

b) 20 – 35

c) 36 – 50

d) 51 – 60.



Mount Kenya University

3. What is your position in the firm or SME?

- a) Top management
- b) Middle management
- c) Supervisory

4. What is your highest level of education?

- a) Secondary level
- b) College level
- c) University level
- d) Post graduate level

5. For how long has the company been in operation?

- a) 3-5 years
- b) 6-8 years
- c) 8-10 years
- d) Over 10 years

6. How many employees does the firm have?

- a) 1-5
- b) 6-15
- c) 16-40
- d) Over 40

7. What is the legal status of your business?

Sole proprietorship	1
Partnership	2
Limited liability partnership	3
Limited liability company	4

Section B: Optimal Financial Factors and Financial Performance

1. When the business was established, from which sources were finances raised?

	Primary Source	Secondary Source
Retained Earnings	1	1
Debt financing	2	2

2. Post start-up of the business, what source(s) of finance does your firm use or has used?

Sources of Finance	Not used	Used
Retained Earnings	0	1
Debt financing (i.e. commercial loans/ mortgages from banks and other financial institutions, bank overdraft, leasing and hire purchase, factoring or sale of account receivable)	0	1

3. Kindly indicate the degree to which you consider the following factors as important in the process of determining your firm's financial structure

Factor	Strongly considered	Considered	No opinion	Not considered	Strongly not considered
Firm Assets					
Firm Growth opportunities					
Trading on equity					
Debt and non-debt tax shields					
Financial flexibility					
Loan Covenant and or agreements					

4. When making a financing decision for your company, which of the following do you consider as important?

Please use the below scale in answering the question

	1	2	3	4	5
Strongly Unimportant	Unimportant	Neutral	Important	Strongly Important	
Factor	Level of Importance				

1	Formal business plan	1	2	3	4	5
2	Formal strategic plan (long-term or short-term plan)	1	2	3	4	5
3	Formal management structure	1	2	3	4	5
4	Business performance appraisal	1	2	3	4	5
5	Close relationship with lender/ supplier	1	2	3	4	5
6	Duration of relationship with lender/ supplier	1	2	3	4	5
7	Review relationship with lender/ supplier on a regular basis	1	2	3	4	5
8	Review procedures in getting credits	1	2	3	4	5
9	Send report to lender/ supplier on a regular basis	1	2	3	4	5
10	Provide data to lender when requested	1	2	3	4	5
11	Review services of lender on regular basis	1	2	3	4	5
13	Invite lender to visit firm	1	2	3	4	5
14	Be regular clients	1	2	3	4	5
15	Pay on time	1	2	3	4	5
16	Visit lender on regular basis	1	2	3	4	5
17	Attitude of debt	1	2	3	4	5
18	Accumulate wealth	1	2	3	4	5
19	Expand firm	1	2	3	4	5
20	Increase firm's value	1	2	3	4	5

5. What other factors do you think influence optimal financial structure for privately owned SMEs

- a.
- b.
- c.

- d.
- e.

6. What is the importance attached to the financial structure decisions by the management?

- a. Great
- b. High
- c. Medium
- d. Average
- e. Low
- f. Nil

7. Do you think the firm's size of operations has any influence on the financial structure decisions?

- Yes
- No

Section C: Debt Financing

1. Has your firm ever used debt financing to finance your business?

- Yes
- No

2. If yes to 1, was it a long-term debt financing or a short term-term debt financing?

- Long-term debt
- Short-term debt

3. What is or has been the impact on interest on the profit position of the enterprise?

a. High

b. Medium

c. Average

d. Low

e. Nil

4. Is your firm able to pay interest on a regular basis?

Yes

No

5. If no to 4, what are the reasons why not?

a.

b.

c.

d.

6. Generally, how can you describe your organization's current state?

Rapidly growing	1
Healthy and growing	2
Stable	3
Declining	4

Section D: Retained Earnings

1. Has or does your firm use retained earnings to finance your business?

Yes

No

2. If yes to 1, how do you accrue your retained earnings to finance your firm?

From Private Investors

From Friends/ Relatives

Financing Institutions

3. What is or has been the impact of retained earnings on the profit position of your firm?

High

Medium

Average

Low

Nil



4. Is retained earnings a long or short term financing option to your firm?

Long term option

Short term option

5. If short term, which other option do you intend to adopt to raise your firm's capital?

a.....

b.....

c.....

Why?

THIS SURVEY ENDS HERE. THANK YOU FOR YOUR PARTICIPATION IN THIS STUDY

APPENDIX IV: LIST OF SMES IN KISII CENTRAL SUB-COUNTY

List of SMEs in Kisi Central Sub-County			
1	Namnyak Safaris and tours	49	Deep Super stores
2	Chifumo Auto Spares	50	Upfront Bookshop
3	Kich Clean Energy	51	Jonzavike Printers
4	M Otieno and Company Advocate	52	Boi Enterprises
5	Mocha Hotel Limited	53	Shoe World Limited
6	ShiltonGleny Consultant Limited	54	Nagka Stationers
7	Stan Agrovat Distributors	55	Levico Agencies General Store
8	Gusii Jumbo Hardware and Paints	56	Sony Agrochemists
9	DukaMoja Animal Feeds	57	Osmo Traders
10	MwamengePosho Mill	58	Keromatt Enterprises
11	SarmanRestraurant	59	Rigia Investments
12	Eedi Cash and Carry Limited	60	Kisii Digital Photo Lab
13	Bro Jobby Limited	61	Remi Executive Centre
14	Double N Kinyozi	62	J Matt Enterprises
15	Sengera Chemist	63	Jumbo Agrovat
16	Gusii Glass and Renovators	64	Nyaranga Pharmacy
17	Aberdares Mattresses	65	Jeliza Traders
18	Harsh Emporium	66	TranswidePharmaceutials
19	Kisii Batteries	67	Cascon Building Designers
20	West Point Electricals	68	Prudent Hotel
21	Stanstud Motors	69	Nabongo Stores
22	San Siro Ceramics	70	NginaGisore General Stores
23	Atlantis Africa Stores	71	JosemoAgrovat
24	Stretch-tech Computers	72	Mega Choice Limited
25	Pishon Investments	73	Bell Electricals
26	Chrismo Boutique	74	Job General Stores
27	Majunior Enterprises	75	Gucha laboratories
28	Ajamal Enterprises	76	Kisii Spare Parts
29	Deriann Cosmetics	77	Nyakoe Chemists
30	Yany Collections	78	Chela Enterprises
31	WimaElectrials	79	Meridian 4 Pharmacy
32	Gucha Electricals	80	Primark Imaging and Diagnostic
33	Four Seasons Limited	81	Bustani Herbs and Nutrition Clinic
34	Busia Electricals	82	American Medical and Cytology Lab
35	Rita Hardware	83	Kisii Discount Stores
36	St Andrews General Stores	84	Liamcare Pharmaceuticals
37	Pishon Investments	85	StansAgrovat

38	Flamingo Hotel	86	Brand House Limited
39	Storm Hotel	87	Pride Kings Security Services
40	Dans Hotel	88	Kisii Security
41	Elm Pharmacy	89	Joy Shopping Centre
42	Deep Super stores	90	Bethsaida Pharmacy
43	Excel hardware and builders	91	Matui Tyres
44	Jakharia Stores	92	Keriniways Hardware Stores
45	Jacks Pharmacy	93	Chamunda Limited
46	Gusii Matt Stores	94	Getembe Prime Distributors
47	Sarka Enterprises	95	Nyandika Chemist
48	Zonic Communications	96	MahantImpex Hardware
97	ACK Mwangaza Bookshop	123	EnochemAgrovet
98	Mwasi Café	124	Mansan General Suppliers
99	Breeze Beauty Parlour	125	Getembe Pharmacy
100	Mwalimu Hotel	126	Mahogany Limited
101	Mashauri Café	127	Falcon Mini Supermarket
102	Soft Price Supermarket	128	Jajo Farm Machinery
103	Siambe Limited	129	KirloskarPosho Mills
104	Geonab Distributors	130	BassiBorabu Pharmacy
105	Nyaongo Pharmacy	131	Ranyao Enterprises
106	Nyakoe Pharmacy	132	Jumco Hardware
107	Modern Cyber Limited	133	Mwania Auto Spares
108	The Nile Hotel	134	Poppy Enterprises Limited
109	NOA Printers and Press	135	Rialli Booksellers
110	Tekalu Logistics	136	Reera Paints and Electricals
111	Mokalo Agencies	137	Omari Motor Spares
112	Watamu Enterprises	138	Suneka Best Bookshop
113	Roho Safi Auto Limited	139	Sunshine Executive Laundry
114	TosacoEletrical Holdings	140	Bonny Bookshop
115	Kanyoni Limited	141	New California Limited
116	Mradi Enterprises	142	Cal Events Studio
117	Matrix Solution	143	Kisii Wine Agencies
118	Mozamad Bookshop	144	Jandy Electricals
119	Fannlex Boutique	145	West Point Electricals
120	Westlink Limited	146	Nyacheki Music Stores
121	Manga Pharmacy	147	Kisii Batteries and Farm Machineries
122	Dynapath Medical Laboratory	148	Dubai Auto Limited
		149	Masaba Discount Stores
		150	Bright Horizons Pharmacy Limited

APPENDIX V: ERC CERTIFICATE



REF: MKU/ISERC/4048

Date: 31 July 2024

TO: MOSES KIRIAGO RATEMO

REG: MBA/2023/45669

Dear Sir/Madam,

RE: INFLUENCE OF FINANCIAL STRUCTURE ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KISII CENTRAL SUB-COUNTY

This is to inform you that **Mount Kenya University** has reviewed and approved your above research proposal. Your application approval number is **2954**. The approval period is **31/07/2024 - 30/07/2025**.

This approval is subject to compliance with the following requirements;

- i. Only approved documents including informed consents, study instruments, MTA will be used
- ii. All changes including amendments, deviations and violations are submitted for review and approval by **Mount Kenya University**
- iii. Death and life-threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to **Mount Kenya University** within 72 hours of notification
- iv. Any changes, anticipated or otherwise that may increase the risks or affect the safety or welfare of study participants and others or affect the integrity of the research must be reported to **Mount Kenya University** within 72 hours
- v. Clearance for export of biological specimens must be obtained from relevant institutions
- vi. Submission of a request for renewal of approval at least 60 days prior to expiry of the approval period. Attach a comprehensive progress report to support the renewal
- vii. Submission of an executive summary report within 90 days upon completion of the study to **Mount Kenya University**

Prior to commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology and Innovation (NACOSTI) <https://research-portal.nacosti.go.ke> and also obtain other clearances needed.

Yours sincerely,



Dr. Alfred Owino, PhD
Chairman, Mount Kenya University ISERC



APPENDIX VI: INTRODUCTION LETTER



DIRECTORATE OF GRADUATE STUDIES

MBA/2023/45669

13th August, 2024

*National Commission for Science Technology & Innovation (NACOSTI)
Off Waiyaki Way, Upper Kabete,
P.O Box 30623- 00100
NAIROBI, KENYA*

Dear Sir / Madam,


RE: MOSES KIRIAGO RATEMO - REGISTRATION NO. MBA/2023/45669

The purpose of this letter is to introduce the above named student who is pursuing **Master of Business Administration** in the department of **Accounting and Finance** in the school of **Business and Economics**

The title of the research is **"Influence of Financial Structure on Financial Performance of Small and Medium Enterprises in Kisii Central Sub-County."** It has been cleared by the University's Ethics Review Committee (Certificate attached) and now has to proceed to the field to collect data between **August 2024, and October 2024.**

Any assistance accorded to the student will be highly appreciated.

Thank you


Dr. Samuel M. Karenga, Ph.D.
Director, Graduate Studies
Enc.

Mount Kenya University
P. O. Box 342 - 01000, THIKA
Office of the Director
Graduate Studies

Main Campus, General Kago Road, P.O. Box 342-01000 Thika.
Tel: 020-2878 000, Cell: +254 709 153 000
Email: info@mku.ac.ke, Web: www.mku.ac.ke
Chartered and ISO 9001 : 2015 Certified Institution.
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APPENDIX VII: NACOSTI PERMIT

 <p>REPUBLIC OF KENYA</p>	 <p>NATIONAL COMMISSION FOR SCIENCE, TECHNOLOGY & INNOVATION</p>
Ref No: 650215	Date of Issue: 05/September/2024
RESEARCH LICENSE	
	
<p>This is to Certify that Mr. Moses Kirirago Ratemo of Mount Kenya University, has been licensed to conduct research as per the provision of the Science, Technology and Innovation Act, 2013 (Rev.2014) in Kisii on the topic: INFLUENCE OF FINANCIAL STRUCTURE ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KISII CENTRAL SUB-COUNTY for the period ending : 05/September/2025.</p>	
License No: NACOSTI/P/24/39494	
650215	
Applicant Identification Number	Director General
	NATIONAL COMMISSION FOR SCIENCE, TECHNOLOGY & INNOVATION
	Verification QR Code
	
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See overleaf for conditions	

APPENDIX VIII: MAP OF THE STUDY AREA



Mount Kenya