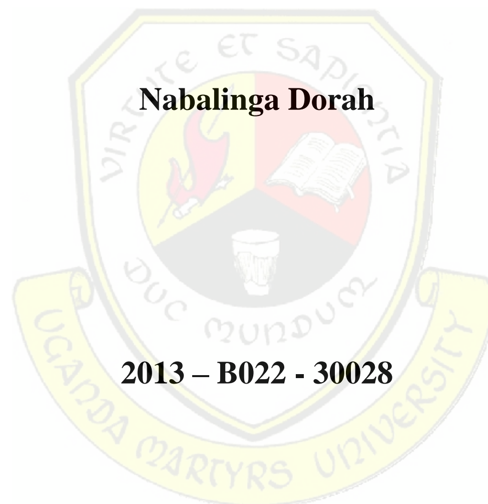
Effect of funding sources on the financial performance of SMEs.

African Queen Uganda Limited



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2013 – B022 - 30028

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April - 2016

Effect of funding sources on the financial performance of SMEs.

African Queen Uganda Limited

An undergraduate dissertation presented to

Faculty of Business Administration and Management in partial fulfilment of the requirements for the award of Bachelors Degree of Business Administration

Uganda Martyrs University

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ACKNOWLEDGEMENT

I Nabalinga Dorah hereby thank the almighty God for how far he has brought me, my mother Florence Sebalinga who has always been there for me in all situations, my sister LindaNalubwama and my brother Solomon Musaazi and my friends for loving me and being there for me. I also thank them for their physical, emotional and spiritual support towards the completion of my book. May God richly bless them. Additionally, I extend my sincere gratitude towards my supervisor Mr. Segawa Edward who really sacrificed a lot to see to it that I finish my book successfully with his enduring guidance, may the almighty God bless the works of his hands. I thank my university too for equipping me with knowledge which smoothened this entire journey of education. I truly appreciate.

TABLE OF CONTENTS

DECLARATION iii
APPROVAL iv
ACKNOWLEDGEMENT v
TABLE OF CONTENTS vi
LIST OF TABLES ix
LIST OF FIGURES x
ABSTRACT xi
CHAPTER ONE 1
GENERAL INTRODUCTION 1
1.0 Introduction to the study 1
1.1 Background to the study. 1
1.1.1 Background to the case study. 5
1.2 Problem statement 6
1.3 General objective 7
1.3.1 Specific Objectives 7
1.4 Research question 7
1.5 Research Hypothesis 8
1.6 Scope of the study 8
1.6.1 Content scope 8
1.6.2 Time scope 8
1.6.3 Geographical scope 8
1.7 Significance of the study 8
1.8 Justification to the study. 9
1.9 Conceptual framework 9
1.10 Definition of key terms 11
1.11 Conclusion 12
CHAPTER TWO 13
LITERATURE REVIEW 13
2.0 Introduction 13

2.1 Theoretical Review 13
2.2 Overview on funding sources. 14
2.2.1 Debt financing as a funding sources. 15
2.2.2 Equity financing as a funding source. 17
2.2.3 Retained earnings as a source of finance. 20
2.3 Overview on financial performance. 22
2.3.1 Liquidity as a measure of financial performance. 22
2.3.2 Profitability as a measure of financial performance. 25
2.3.3 Solvency as a measure of financial resources. 28
2.4 Actual Review of literature 30
2.4.1 Relationship between Debt financing and financial performance. 30
2.4.2 Relationship between Equity financing and financial performance. 32
2.2.3 Relationship between Retained earnings and financial performance. 34
CHAPTER THREE 36
METHODOLOGY 36
3.1 Introduction 36
3.2 Research design 36
3.3 Area of study 36
3.4 Study population 37
3.5 Sample size and selection 37
3.5.2 Sampling technique 38
3.6 Data collection sources 38
3.7 Data collection tools. 38
3.7 Quality Control 39
3.7.1 Validity 39
3.7.2 Data reliability 39
3.8Data management and Analysis 39
3.8.1 Quantitative data 39
3.8.2Qualitative data 40
3.9 Ethical consideration 40
3.10 Limitation to the study 40
3.11 Conclusion 41

CHAPTER FOUR 42
DATA PRESENTATION, ANALYSIS AND DISCUSSION 42
4.0 Introduction 42
4.1 Response rate 42
4.2 Bio data 42
4.2.1 Gender of respondents 42
4.2.2 Age bracket of respondents 43
4.2.3 Duration of service with the company 44
4.3 Descriptive statistics on Debt financing 46
4.4 Descriptive statistics on Equity Financing 48
4.5 Descriptive statistics on Retained Earnings 51
4.6 Descriptive statistics on financial performance 54
4.7 Correlation Analysis 57
4.7.1 Correlation between Debt financing and financial performance 57
4.7.2 Correlation between Equity financing and financial performance 58
4.7.3 Correlation between retained earnings and financial performance 59
4.8 Conclusion 60
CHAPTER FIVE 61
SUMMARY, CONCLUSION AND RECOMMENDATIONS 61
5.0 Introduction 61
5.1 Summary of findings 61
5.2 Conclusions 62
5.3 Recommendations 63
5.4 Areas of further research 64
5.5 Conclusion. 64
APPENDIX 65
QUESTIONNAIRE 65
References 70

LIST OF TABLES

Table 1: Category of sample size 37
Table 2: Gender of Respondents 42
Table 3: Age bracket of respondents 43
Table 4: Duration of Service with the company .... **Error! Bookmark not defined.**
Table 5: Descriptive Statistics on Debt financing 46
Table 6: Descrptive Statistics on Equity financing .... **Error! Bookmark not defined.**
Table 7: Descriptive Statistics on Retained Earnings 52
Table 8: Descriptive Statistics on Financial performance 54

Figure 1: Conceptual Framework 10
Figure 2: Gender of Respondents 43
Figure 3: Age bracket of respondents 44
Figure 4: Duration of Service with the company 45

LIST OF FIGURES

Figure 1: Conceptual Framework 10
Figure 2: Gender of Respondents 43
Figure 3: Age bracket of respondents 44
Figure 4: Duration of Service with the company 45

ABSTRACT

The study focused on establishing the effect of funding sources on the financial performance of SMEs, a case study of African Queen Uganda Limited. The research objectives were to establish the effect of debt financing on the financial performance of SMEs, effect of equity financing on financial performance of SMEs and the effect of retained earnings on the financial performance of SMEs.

The research design was case study adopting both quantitative and qualitative approaches. A structured questionnaire was used to collect data which was analysed using the Statistical Package for Social Scientists (SPSS). Both descriptive and inferential statistics were generated, presented and analysed to derive the relationships between the different variables.

Results showed that there is a positive and significant effect ($r = 0.542$, $p < 0.01$) between debt financing and financial performance of SMEs, a positive and significant effect ($r = 0.518$, $p < 0.01$) between equity financing and financial performance and also a positive and significant effect ($r = 0.554$, $p < 0.01$) between retained earnings and financial performance of SMEs.

Based on these results the study concluded that sources of finance for SMEs have a positive and significant effect on the financial performance of SMEs. Key recommendations made by the study included; SMEs only going in for debt financing after making some profits and assets to act as security since debt repayment may involve loose of business ownership., SMEs should also go for equity financing after they have well evaluated the percentage they are willing to sell out to the investors in exchange for funds, and finally retained earnings should be accompanied by other funding sources since it is limited and excess ploughing of it back to the business may cause the business lose its profitability.

CHAPTER ONE

GENERAL INTRODUCTION

1.0 Introduction to the study

This research intended to examine the effect of funding sources on the financial performance of small and medium enterprises. Funding according to Merriam – dictionary, refers to the act of providing financial resources usually inform of money or other values such as effort and time to finance a need, project or enterprise. There are several ways through which businesses are funded, among them are; individual savings, family and friends contribution, loans, grants, donations, retained earnings and many more.

According to Kasekende, L.A. (2001), Small and Medium Enterprises (SMEs) are widely defined in terms of their characteristics which include the size of capital investment, number of employees, turnover, management style, location and market share.

This chapter examined the background to the study, problem statement, general and specific objectives, the research question, scope of the study, hypothesis, significance of the study, justification of the study, conceptual framework and the conclusion.

1.1 Background to the study.

SMEs are non – subsidiary independent firms which employ less than a given number of employees, however the number varies across countries. According to the European commission, SMEs are businesses or companies that have fewer than 250 employees and have either annual turnover not exceeding 50 million pounds or an annual balance sheet total not exceeding 43 million pounds. In the accent days a funding was through barter trade where goods were exchanged for other goods (Glyn Davies, 2002). However, monarch or governments in all

wisdom came up out of the blue with an idea that instead of each party getting what they want in exchange that one party would accept something that they do not want at all but use it for its own use. This was how money came into existence as medium for exchange (Glyn Davies, 2002).

The asset finance UK, (2015), there is no underestimating the importance of SMEs for the UK, the market is key driver of economic growth and contribute greatly to the gross domestic product, statistics released by the department of business innovation and skills, UK (BIS) reveals that 99.9% of 5.2 million private sector businesses are SMEs and together contribute an annual turnover of 1.6 trillion pounds. The SMEs dominate the industrial market and account for 60% of private sector employment, supporting them is vital for economic growth enabling business to acquire the finance they need in order to succeed and grow, (Karen .B, 2013).

According to Phil Mitchell, (2015), the economy may be showing signs of growth but SMEs bank lending continues to be difficult to fund. The Bank of England (2014) reveals that average monthly bank lending flow to UK business was negative. Phil Mitchell (2015), categorised financing into two broad categories that is borrowing and capital investment. He explains borrowing as a means through which business services a debt and capital investment involves giving up some part ownership to the investor.

Pischke J.D, (1996), looks at SMEs for developing countries as those enterprises that employ less than 50 workers. In Africa SMEs are important drivers for growth in economies across sub-Saharan Africa accounting up to 90% of all businesses in the market (International Finance Corporation). Supporting SMEs growth and competitiveness is therefore a central role. African SMEs historically lack access to finance and this is likely to be exacerbated by the effects of the financial and economic crisis on the continent (African development bank report, 2010). There is

a strong economic case for scaling up support for African SMEs development is highly fragmented with several donors, government schemes, grants, and development finance institutions running a number of SMEs programmes. According to the African Development Bank report,(2014), indicates that support from banking sectors through loans has helped to stimulate the growth of SMEs, the bank projects to support SMEs to support SMEs has brought about well diversified spanning of all economic sectors including manufacturing, commerce and trade. However SMEs still face challenges in accessing funds, access to finance from formal sector, most businesses struggle to raise finance for their businesses and use alternative fundraising avenues like borrowing from money lenders. The African Guarantee Fund (AGF), 2012 launched a scheme designed to ease access to finance for Africa's SMEs. The African Development Bank, the Spanish government and the Danish government came together to create AGF with a mission of providing, among other services financial guarantees to banks on behalf of bankable SMEs. AGF's guarantee facilities as well as SMEs banking capacity development assistance will enable banks to significantly scale up their SMEs lending activities. This programme works in several African countries including Nigeria, Tanzania and many more. In Nigeria SMEs hold immense potential for generating employment opportunities, development of indigenous technology, and diversification of economy. Most of the businesses in the country fund their businesses through schemes, personal savings and many more.

In Uganda SMEs crop up every day but many of them fail before they can celebrate their first year in business, they also lack creditworthiness and poor management skills so they have trouble securing funds, some lack collateral and have capacity to absorb only small amounts of funds (Kasekende, L.A, 2001). In the studies of Uganda Bureau of Statistics, (2003) and Snyder, (2001), it was established that funding of SMEs in Uganda is obtained from both informal and

formal sectors. The private sector foundation, (2005), points out that informal financing arrangements are the most sources of finance to SMEs which include individual savings, re-investment of profits, social network of family and friends. The source of finance make SMEs vital for existence at all stages as they provide funds to foster smooth running of an enterprise's daily activities, financing liabilities of a firm which permits a steady financial performance and growth measured through the firm's returns, profitability, liquidity, solvency and many more.

According to the business dictionary Performance is the accomplishment of a given task measured against pre-set known standards of accuracy, completeness, cost and speed. On the other hand financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. Financial performance is measured by the use of financial ratios (Chirantan Basu, 1995). These ratios express the relationships between financial items, management uses this information to identify internal strengths and weaknesses, and estimate future performance (Chirantan Basu, 1995). Investors can use these ratios to compare companies in the same industries. Ratios that measure performance include liquidity, solvency, and profitability.

The most common ratio is the current ratio which is Liquidity**.** It is the ratio of current assets to current liabilities (Kendra .J, 2001). This ratio indicates the company's ability to pay short term bills. A ratio of greater than one means is usually mean because anything less than one means the company has more liabilities than assets while a high ratio indicates more of a safety cushion which increase flexibility because some of the inventory items and receivables balances may not be easily convertible to cash (Chirantan Basu, 1995). Companies can improve their current ratio by paying down debt, converting short term debt into long term debt, collecting its receivables faster and buying inventory only when necessary (Kendra .J, 2001).

Solvency ratio judges the ability of a company to raise capital and pay its obligations (Kendra .J. 2001). Solvency ratios which include debt to worth and working capital, determine whether an entity is able to pay all of its debts. Debt to worth ratio calculation is total liabilities divided by net worth, working capital calculated by subtracting current liabilities from current assets (J. Balunwa, 2007). Solvency ratios indicate financial stability because they measure a company's debt relative to its assets and equity, a company with too much debt may not have flexibility to manage its cash flow if interests rise or if business conditions deteriorate (Chirantan Basu, 2010).

Profitability indicates management's ability to convert sales into profits and cash flow. The common ratios are gross margin, operating margin and net income margin. Gross margin is the ratio of gross profit to sales. The gross profit is equal to sales minus cost of goods sold. The operating margin is the ratio of operating profits to sales and net income margin is the ratio of net income to sales. The operating profit is equal to the gross profit minus operating expenses, while the net income is equal to the operating profit minus interest and taxes (Kendra .J, 2001).

Ratios analysis is a form of fundamental analysis that links together three financial statements commonly produced by co-operations (Joe.Ian, 2012). Ratios provide useful figures that are comparable across industries and sectors.

1.1.1 Background to the case study.

African Queen (AQ) Limited is a privately owned Ugandan company specializing in improving, distributing and marketing high quality Fast Moving Consumer Goods (FMCG). Baker (1992) defines 'FMCG's as products that are sold quickly and at a relatively low cost. Examples of these goods include non-durable goods such as soft drinks, toiletries, toys processed goods among others. African queen with its headquarters in Namanve is boosted by many years of experience in distribution, with incorporation in 2001. AQ has always endeavoured to satisfy the

needs of the Ugandan market by providing not only the best quality brands but also with the most suitable and affordable prices.

African Queen began its operations in 1994 with the buying and selling of cosmetic products on a small scale. The company changed its business model in 1997 and began wholesale distribution to date. African Queen has expanded its product range to include a wide array of cosmetics, toiletries and food products and is continuously looking for opportunities to grow its range of products while offering trade credit and dealing with strong well-known brands. With headquarters in Namanve, Mukono in Uganda off the Kampala-Jinja highway which connects Kampala to Nairobi and Mombasa. AQ has several branches in Mbarara, Kampala-Kikubo, Mbale, Lira, and Masaka.

The researcher choose African Queen as a case study because it qualifies as an SME and its strategic location giving room for easy access to data and information which will help in facilitation the research process.

1.2 Problem statement

The Bank of Uganda quarterly and annual reports, (2012), provide that SMEs are widely defined in terms of their playing a strategic role in the economic growth and development of the country through employment, income generation and others. The reports also provide that the bank and the government have designed programmes and policies that are market driven to support SMEs. On the other hand micro-finances are doing a good job in helping SMEs access funds through charging fair interest rates on borrowing, co-operations like SACCOs also help in improving the funding system of SMEs.

Given the above, SMEs still face several challenges among them, failure to have adequate funds to operate. Osunsan and Sumil, (2012), indicate that SMEs are owned by individuals who rely on informal sources of finance however the value of funds raised is often inadequate due to low income levels by the contributing factors that is relatives and savings. Most SMEs fail before they can celebrate their first year in business, they also lack credit worthiness and management so they have trouble securing funds, some lack collateral and have capacity to absorb only small amounts of funds (Kasekende, L.A, 2010).

Finance plays a central role in enterprise's growth and development but this is only possible if it is accessible and reasonably priced. While SMEs are increasingly recognised as playing a strategic role in economic growth and development, they still suffer from liquidation, solvency and profitability and a number of other challenges. This study therefore intends to examine the effect that different funding sources actually have on the financial performance of SMEs.

1.3 General objective

To examine the effect of funding sources on the financial performance of SMEs.

1.3.1 Specific Objectives

- To find out the effect of debt financing on financial performance of SMEs.
- To identify the effect of equity financing on financial performance of SMEs.
- To find out the effect of retained earnings on financial performance of SMEs.

1.4 Research question

- What is the effect of debt financing on financial performance of SMEs?
- How does Equity financing determine the financial performance of SMEs?
- How do retained earnings lead to financial performance of SMEs?

1.5 Research Hypothesis

Funding sources have a positive and significant effect on the financial performance of SMEs.

1.6 Scope of the study

The scope examined the content scope, time scope and the geographical scope of the study.

1.6.1 Content scope

The research examined the effect of funding sources to the financial performance of SMEs having funding sources as the independent variable with dimensions like, debt financing, equity financing and retained earnings. Financial performance of SMEs was the dependent variable and was assessed using liquidity, profitability and solvency.

1.6.2 Time scope

The study was to focus on the following financial years that is, (2010-2015). This was because the period provided more current and valid information to the research problem in question.

1.6.3 Geographical scope

The research was to be carried out within Mukono town area off Jinja – Kampala high way and Kampala outlet of kikuubo opposite old taxi park on giant arcade, African Queen is located here hence easy gathering and access to the necessary information for the study.

1.7 Significance of the study

- Academicians might benefit from the study while carrying out more research in relation to the study's field.
- SMEs might benefit from the study by adapting a scholarly funding analysis procedure.
- The government might benefit from the study by imposing appropriate taxes on SMEs.

- African Queen will benefit from the study by identifying the gaps in business operations and seeking better funding sources which will enable boost their financial performance.

1.8 Justification to the study.

Most SMEs operate on the basis of acquiring funds from various sources. Funding comes with a lot of administrative and financial constraints. Therefore this research should be carried out to find out the effectiveness of funding sources in boosting the financial performance of SMEs.

SMEs fail before they could celebrate their first year in business due to lack of enough funds to run the enterprises daily activities given the various sources of funds therefore the researcher intends to find out these funding sources impact on financial performance of SMEs.

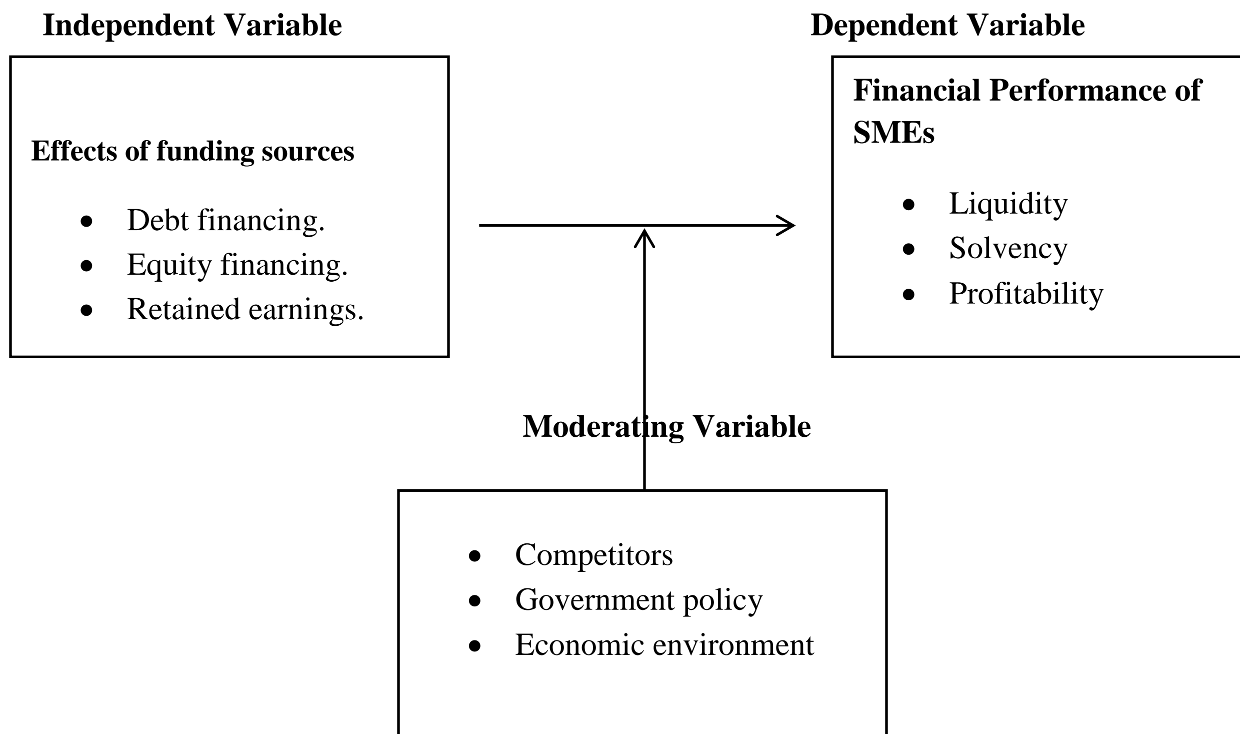
1.9 Conceptual framework

Njeru et al, (2012), establish that retained earnings is an important source of financing for SMEs and one of the cheapest source of funding that SMEs should employ. Re-investment of the earned profits helps to increase on the firm's liquidity and reduces the use of micro - financing source and its chargeable interest (Odongo, 2014).

Alexandra, (2006), noted that access to external funding helped to ease cash flow management, generate more institutional income, increase membership size and promote training and capital building.

Atieno, (2006), and Steel, (2004), reveal that limited access to credit can also negatively affect profitability and financial survival if firms operate under poor economic conditions and high interest rates. On the other hand, if credit is accessible and reasonably priced, firms can address their liquidity constraints in turn aiding profitability (Laferrara, 2003).

Figure 1: Conceptual Framework



Source; Adapted from Atieno, (2006), and Steel, (2004), Alexandra, (2006), and Njeru et al, (2012) and modified by the researcher

The independent variable in this case is the funding sources which include; debt financing, equity financing and retained earnings. Dependent variable being financial performance assessed through profitability, solvency and liquidity. Moderating variable include the competitors, government policy and the economic environment, these will influence the performance of SMEs regardless of the independent variable. For example debt financing increases the level of a firm's funding leading to increase in liquidity of the firm to enable it finance its short term liabilities hence smooth flow of business operations. However, given the moderating variable like economic environment including inflation which brings about charging high interest on borrowing, firm's profits will be affected hence decline in profitability.

1.10 Definition of key terms

SMEs are small and medium sized enterprises which employ less than a given number of employees from 5 to 250 employees, European Union**.**

Financial Performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It can be accessed through profitability, returns, solvency and many more.

Liquidity is the measure of the extent to which a person or organisation has cash to meet immediate and short term obligations. It is measured by deducting current liabilities from current assets.

Solvency is the ability of a firm to meet its long term financial obligations.

Debt financing is the act of business raising operating capital or other capital through borrowing. Through acquiring a loan from financial institutions like Banks, micro- finance etc.

Equity financing is the form of raising capital by selling a firm's stock to investors in return for investment; the shareholders receive ownership and interest in a company. Essentially it is the sale of ownership interest to raise funds for business purposes.

Retained earnings is the percentage of net earnings not paid out as dividends, but retained by the company to be reinvested in its core business, or to pay debts. It is recorded under shareholder's equity on the balance sheet.

1.11 Conclusion

This chapter has reviewed the background to the study, problem statement, general and specific objectives, the research question, scope of the study, hypothesis, significance of the study, justification of the study, conceptual framework.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter reviews the literature to the study. The theoretical review, overview on funding sources translated into three sub themes, overview on financial performance, actual review and conclusion.

2.1 Theoretical Review

Pecking order states that firms have a preferred hierarchy for financing decisions. The highest preference is to use internal financing that is retained earnings and the effects of depreciation before resorting to any form of external funds (Brealey R.A, et al, 2008). Internal funds incur no flotation costs and require no additional disclosure of proprietary financial information. If a firm must use external funds, the preference is to use the following order of financing sources, debt, convertible securities, preferred stock and common stock (Myers 1984). The theory was first suggested by Donaldson in 1961 and it was modified by Stewart C Myers and Nicolas Majluf in 1984 (Allen F, 2008).

According to Allen F, (2008), the order reflects the motivations of financial managers to retain control of the business. The theory also explains the inverse relationship between profitability and debt ratios; they adapt their dividend pay-out ratios to their investment opportunities, while trying to avoid sudden changes in dividends, firms prefer internal financing sources, Matemilola, B.T; Bany A.N, (2011).

Brealey R.A, et al, (2008), establishes that if capital expenditure is less, the firm first draws down its cash balance or sells its marketable securities rather than reducing dividends, if external financing is required, firms issue the safest security first that is, debt then hybrid securities such as convertible bonds then equity as the last resort (Bany A.N, 2011). Issue costs are least for internal funds, low for debt and highest for equity (Allen F, 2008).

2.2 Overview on funding sources.

Funding is the act of providing financial resources usually in the form of money or other values such as effort or time to finance a need. (Business Dictionary). Generally funding is used when a firm uses internal reserves to satisfy its necessity for cash, while financing is used when the firms acquire capital from external sources (Clifford C, 2014).

SMEs finance is the funding of small and medium-sized enterprises, and represents a major function of the general business market in which capital for different types of firms are supplied, acquired and priced (Potts and Jason, 2007). Funds are supplied through the business in the form of credit, venture capital, donations, savings, grants, debt, peer to peer and many more sources of finance (JOBS Act, 2012).

The Act also reveals that funding sources such as donations, subsidies and grants that have no direct requirement for return on investment, crowd funding and soft funding facilitates the exchange of equity ownership in a company for capital investment.

In the studies of Uganda Bureau of Statistics, (2003) and Snyder, (2001), it was established that funding of SMEs in Uganda is obtained from both informal and formal sectors. The private sector foundation (2005). Support from the government schemes, grants has helped to stimulate

the growth of SMEs in the UK and African. The Bank of England report, (2010), reveals that most businesses in the UK are funded by business loans and overdraft.

2.2.1 Debt financing as a funding sources.

Debt generally refer to something owed by one party, the borrower or debtor, to a second party, the lender or creditor can be a Bank, credit card company, payday loan provider or an individual (Rose, R.L. 2012).

Debt financing refers to that amount of capital raised by taking a loan. It is a strategy that involves borrowing from a lender or investor with the understanding that full amount will be repaid in the future usually with interest (David L. 2003).

Potts and Jason, (2007), establish that debt financing can be long term or short term. Short term debt financing includes debt securities with short redemption periods and used to provide day to day necessities such as inventories and payroll. Long term debt financing usually involves a business need to buy the basic necessities for its business such as facilities and major assets.

Debt ratios in large firms have been examined by a number of researchers while small firms have attracted less attention to it (Akhtar, 2005). Brown et al (2010), establish that debt financing involves the procurement of interest bearing instruments, they are secured by asset – based collateral and have term structures that is either short or long term.

Debt financing is the major source of capital for truly nascent firms since the retained earnings are insufficient or not available (Robb and Robinson, 2008). According to Sun (2010), SMEs depend on debt financing because it is relatively cheaper compared to equity financing.

Small businesses that employ debt financing accept a direct obligation to repay the funds within a certain period of time (Graham, 2000). The interest charged on the borrowed funds reflects the level of risk that the lender undertakes by providing the money.

Particularly, debt financing can be a useful strategy for companies with good credit and stable history of revenue earnings and cash flow but small business owners should think carefully before committing to debt financing in order to avoid cash flow problems and reduced flexibility (Robb and Robinson, 2008).

According to Kayanula and Quarley, (2000), SMEs are the backbone of all economies, they are considered as key component and players in national development. However they still experience various difficulties in improving their financial performance since short term loan, trade credit and long term loans are not well managed (Brown et al, 2010). Nevertheless, the abundance of loan facilities plus the demanding approval requirement of the scanty available funds has led many of SMEs to resort to debt (Akhtar, 2005).

SMEs are still unable to access loans from financial institutions due to conditions attached to the loans which make debt financing a difficult source of funding (European Union Report, 2008). This has hindered the performance of these businesses as the required capital to run the day to day operations are insufficient (Ricupero, 2002).

Ocansey (2006), establishes that financial institutions required collateral in the form of assets as a way for them to recover their money in events of default, this is a major hindrance of SMEs to acquire debt finances hence failure to raise the required capital for business operations.

Debt financing allows the founders of the business to retain ownership and control of business. Entrepreneurs are able to make decisions and also retain their profits (Brealey R.A. 2008). Debt obligations are limited to the loan repayment period after which the lender has no further claim on the business. Furthermore a debt that is paid on time can enhance a small business' credit rating and making it easier to obtain various types of financing is the future (Allen .F, 2008).

According to Kasekende, (2001), a debt is easy to administer as it generally lacks the complex reporting requirements and tends to be less expensive for small businesses over long term period though more expensive over short term. However, debt financing requires that a small business to make regular monthly payments of principal and interest as it reduces the firm's returns (Clifford .C, 2014).

Most lenders provide severe payments for late or missed payments which include charging late fees, taking the possession of collateral payments on a loan failure to pay credit can affect small business' credit rating (Ocansey, 2006).

Overall debt financing can be a valuable option for SMEs that require cash to begin or expand their operations but experts warn that carrying too much debt can cause a firm to encounter severe cash flow problems, instead it's better to use a combination of different forms of financing in order to spread the risk and facilitate future funding effort (Richard .L, 2000).

2.2.2 Equity financing as a funding source.

Equity financing is the method of raising capital by selling company stock to investors in return for investment the shareholders receive ownership interests in the company (Gavin Davis, 2003).

According to David L and Scot, (2001), equity financing involves the sale of the company's stock and giving a portion of ownership of the company to investors in exchange for cash. The proportion of the company that will be sold in an equity financing depends on how much the owner has invested in the business and what that investment is worth at the time of financing.

Equity financing is a method of raising capital for the business before it is profitable enough in exchange for diluted ownership and general control of the business. This method of financing is important for investors as they acquire ownership in the business (Michel Lebas, 2006).

Richard .L, (2000), establishes that an entrepreneur who invests $ 600,000 in start-up of the company will initially own all of the shares of the company, as the company grows and requires further capital, the entrepreneur may seek an outside investor such as venture capitalist, if the investor is willing to pay $ 400,000 and agrees to share price of $1.0, then the total capital will be raised to $1000,000, the owner will control 60 percent and the investor controls 40 percent of the company shares.

During the early stages of a business' growth, particularly when the business does not have sufficient revenues, cash flow or hard assets to act as collateral, equity financing can attract capital from early stage investors who are willing to risk along with the entrepreneur (Michel Lebas, 2006). When the business has matured and established, has assets and cash flow, it can raise substantial capital through an equity financing such as a public offering in the capital markets.

According to Jay Wagner, (2013), equity financing is as necessary to a business as air is to a person but because it comes in several forms, it can easily be misunderstood. Equity allows you to stay out of debt, but gives up a percentage of the business and profits to an investor (Clifford

.C, 2014). Michel Lebas, (2006), reveals that equity financing can sometimes prove to be more appropriate than other sources of finance, that is bank loans, but it can place different demands on the business hence requires full study and understanding before it is undertaken into account.

This form of financing involves not just the sale of common equity but also the sale of quasi-equity instruments such as preferred stock, convertible preferred stock (Kasekende, 2001). A start-up that grows into a successful business will have several rounds of equity financing as it evolves.

There are various forms of equity investors that a business can attract depending on the industry stage and size of the business (Ocansey, 2006). Common sources of equity financing to SMEs include; personal savings, contribution from friends and family, venture capitalist, business angels, government schemes and many more.

Venture capitalist and business angel provide funds to businesses that they believe have exceptional growth potential this limits a number of SMEs to acquiring this financing, firms can also access equity from its employees as a form of offering part ownership to them, and instead of paying for say a bonus, the money is given inform of shares which gives an employee a given percentage of ownership, the reserved amount is used to invest into the business operations (Carter Michael, 2004).

Equity financing revolve around risk and reward, under the provisions of bankruptcy law, creditors are the first in line when a business fails and owners come last and are therefore at a higher risk.

Equity financing seems advantageous to SMEs in a way that it needs not to be paid back like what happens with bank loans and other forms of debt financing, as it has an immediate impact on cash flow and carry severe penalties unless payment terms are met (Jay Wagner, 2013).

Start-ups with good ideas and sound plans are more likely to have access to equity financing. Investors primarily seek opportunities for growth and are more willing to take a chance on a good idea to finance (Galen, et al, 2005).

However equity financing disadvantage is the issue of control. If investors have different ideas about a company's strategic direction or day to day operations, this can pose problems for the entrepreneur, the differences may not be obvious at first but may emerge as the business grows (Galen, et al, 2005). In addition, some sale of equity can be complex and expensive.

Overall equity financing can be an attractive option for many SMEs but experts suggest that best strategy is to combine equity with other types of financing including debt finance to ensure that enough options will be available for later financing needs (Carter, Michael 2004).

Joel Margils, (2005) establish that entrepreneurs must approach equity financing cautiously in order to remain the main beneficiaries of their own hard work and long term business growth.

2.2.3 Retained earnings as a source of finance.

Retained earnings means that part of trading profit which is not distributed in the form of dividends but retained by directors for future expansion of the business (Karen .B, 2013).Retained earnings ultimately come back to the equity shares in the form of enhanced dividend or capital gains.

Retained earnings are one important source of internal financing used for fixed as well as working capital (Phil Mitchell, 2015). They increase the value of shareholders in case of a growing firm. There are important features of retained earnings as a source of finance including; cost of financing, flotation cost, control and legal formalities.

According to (Michel Lebas, 2006), retained earnings are an internal source of finance available to the company, in other words shareholders also referred to as internal equity. Companies save 30 to 80 percent of profit after tax for financing growth.

“Ploughing back of profits” in the business which is retained earnings depends upon many factors; net profit, dividends policy and the age of the organisation. This source of finance is a permanent source of funds available to an organisation.

Retained earnings do not involve any explicit costs in the form of interest, dividend or flotation cost making it a better option for funding to SMEs. According to Carter, Michael, (2004), as funds are generated internally, there is a greater degree of operational freedom and flexibility.

This source of finance strengthens the financial position of a business and therefore gives financial stability to the business.

When deciding how to finance a new business, there is a tendency to guard capital and minimize the distribution of dividends to shareholders. This follows with the pecking order theory of financing whereby companies prefer internal sources of capital to external financing, this is because the firm does not have to incur transaction costs to obtain it nor does it have to pay the taxes associated with paying dividends (Karen .B, 2013).

Retained earnings are viewed as a favourable internal source of finance because of, ready availability, cheaper than external equity, no ownership dilution and positive connotation (Kasekende, L.A, 2001). Being an internal source is readily available to management and directors do not have to ask outsiders for finance.

This form of finance is cheaper than external equity because the flotation costs, brokerage cost, underwriting commission and other issue expenses are eliminated (Glyn Davies, 2002).

Given retained earnings, there is no ownership dilution relying on them which eliminates fear of ownership being diluted between the owner and the external investors of equity and loss of control to existing shareholders.

However limited funds are realised with retained earnings, keeping in view, a stable dividend policy, the director cannot exhaust the whole balance retained (Brown et al, 2010).

David L and Scot, (2001), reveals that, use of retained earnings should be accompanied with other funding sources as excessive ploughing back of profits may cause dissatisfaction amongst the shareholders as they could get lower dividends.

2.3 Overview on financial performance.

2.3.1 Liquidity as a measure of financial performance.

Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the assets' price (Potts and Jason, (2007). Accounting liquidity measures the ease with which an individual or company can meet their personal obligations with the liquid assets available to them.

According to Jay Wagner, (2013), cash is considered the standard for liquidity because it can most quickly and easily be converted into other assets that are a person wanting to purchase a 300.000 dollar television set, cash is that asset that can easily be used to obtain it.

Liquidity for a company or entity is the measure of their ability to pay off debts as they fall due. In order to survive, firms must be able to meet short term obligations, pay their creditors and repay their short their short term debts thus liquidity is one measure of a firm's financial health (Akhtar, 2005).

Allen F, (2008) establishes that when measuring the financial health of a firm using liquidity, several ratios are used, that is current ratio and the quick ratio. Quick ratio measures a firm's ability to meet its short term obligations with its most liquid assets. For this reason, the ratio excludes inventories from current assets, and is calculated as follows; (current assets - inventories) divided by (current liabilities).

The quick ratio measures the dollar amount of liquid assets available for each dollar of current liabilities. Thus a quick ratio of $ 1.5 means that a company has $ 1.5 of liquid assets available to cover each $ 1 of current liabilities (Glyn Davies, 2002). The higher the quick ratio, the better for the company's liquidity position.

Quick ratio is more conservative than the current ratio because it excludes inventories from current assets, the ratio derives its name presumably from the fact that assets such as cash and marketable securities are quick sources of cash, inventory however, takes time to be converted into cash and if they have to be sold quickly, the firm may have to accept a lower price than book value of these inventories, as a result they are justifiably excluded from assets that are ready sources of immediate cash (Richard loth,2014).

Current ratio is a liquidity ratio that measures whether or not a firm has enough resources to pay its debts over the next twelve months; it compares the firm's current assets to its current liabilities (Ocansey 2006). It measures the company's ability to meet both its short and long term obligations. To gauge this ability, the current ratio considers the total assets of a firm both liquid and illiquid relative to that firm's total liabilities (Joel Margils, 2005). Current ratio equates to current assets divided by current liabilities, this ratio unlike other liquidity ratios, it incorporates all current assets including inventory and current liabilities.

According to Eileen. T, (2005), current ratio is mainly used to give an idea of the company's ability to pay back its liabilities that is debt and accounts payable with its assets, cash, marketable securities, inventory and accounts receivable. As such, current ratio can be used to take a rough measurement of a business' financial health. The higher the current ratio, the more capable the business is of paying its obligations, as it has a larger proportion of asset value relative to the value of its liabilities (Galen, et al, 2005).

Richard .L, (2000), establishes that a ratio under 1 indicates that a business' liabilities are greater than its assets and suggests that the business in question would be unable to pay off its obligations if they come due at the point. While a current ratio below 1 show that the business is not in good financial health, it does not necessarily mean that it will go bankrupt. There are many ways for a business to access financing, and in this case if a business has realistic expectations of future earnings against which it might borrow. For example, if a business has a reasonable amount of short-term debt but expecting substantial returns from a projector other investments not too long after its debts fall due, it will likely be able to stave off its debt (Carter, Michael 2004). All the same a current ratio below 1 is usually not a good sign for the business.

On the other hand, (Joel Margils, 2005), reveals that a high ratio over 3 does not necessarily indicate that the business is in a state of financial well- being either. Depending on how the firm's assets are allocated, a high current ratio may suggest that the firm is not using its current assets efficiently, is not securing financing well or is not managing working capital well, to better assess whether or not these issues are present, a liquidity ratio more specific than current ratio is needed (Karen .B, 2013).

Firms establish which ratio to use to determine their financial performance by rating the two ratios that is quick and current liquidity ratio. The higher the liquidity ratios are, the higher the margin of safety that the firm possess to meet its current liabilities. Liquidity ratio greater than 1 indicates that the firm is in good financial health and is less likely to fall into financial difficulties (Phil Mitchel, 2015).

Caution should always be exercised when drawing conclusions on the liquidity of a company because an entity's liquidity may be affected by many factors; these include the business cycle, season, manipulation of year end balances, the nature of business, overtrading or potential liabilities not included in the financial statement (Jay Wagner, 2013).

2.3.2 Profitability as a measure of financial performance.

Profitability is the ability of a business to earn a profit. Profit is what is left of the revenue a business generates after it pays all expenses directly related to generation of revenues (Shawn Grimsley, 2003).

Profitability is measured with income and expenses, income is money generated from activities of the business for example if crops and livestock are produced and sold, income is generated. However money coming into the business from activities like borrowing money do

not create income, this is simply a cash transaction for operating the business or buying needs (Laferrara, 2003).

Karen .B, (2013), establishes that profitability is measured with “income statement.” This is essentially a listing of income and expenses during a period of time usually a year for the entire business. An income statement traditionally is used to measure profitability of the business for past accounting period and predicting the future performance of the business (Glyn Davies, 2002).

Kendra .J, (2001.), reveals that profitability determines whether a business stays in business or not this is analysed through the profitability ratio. Profitability ratio is the measure of the business’ ability to generate revenue compared to the amount of expenses it incurs (Robb and Robinson, 2008). Profitability ratios indicate the management’s ability to convert sales into profits and cash flow. The common ratios in establishing this are gross margin, operating margin and net income margin.

Gross margin is the ratio of gross profit to sales. Eileen. T, (2005) establish that gross profit margin measures the cost of production. Gross profit margin equals gross profit divided by net sales times 100. For example gross profit of $ 125,000 and net sales $ 3,750,000, gross profit margin will equal to 125,000 divide by 3,750,000 multiplied by 100 which will give 33 percent. Gross profit earned at 33 percent means that out of each dollar the business makes in sales, it spends a little over 66 cents to produce the product (Shawn Grimsley, 2003).

Operating margin is a ratio used to measure a firm’s pricing strategy and operating efficiency. It measures a proportion of a firm’s revenue left over after paying for variable costs of production such as wages, raw materials etc. (Richard .L,2000), It can be calculated by dividing a firm’s

operating income during a given period by its net sales. Operating income refers to profit that a firm retains after removing operating expenses and net sales here refer to total value of sales minus the value of returned goods, allowances for damaged and missing goods, and discount sales (Jay Wagner, 2013).

The margin gives analysts an idea of how much a company makes before interest and taxes on each dollar of sales. The higher a firm's operating margin is, the better off the firm is. If a firm's margin is increasing, it is earning more per dollar of sales (Akhtar, 2005).

A firm's operating margins often determines how well it can satisfy creditors and create value for shareholders by generating operating cash flow. A healthy operating margin is also required for a company to be able to pay for fixed costs, such as interest on debt, so a high margin means that a company has less financial risk than a company with a low margin (Allen .F, 2008).

According to Brown et al, (2010), net profit margin is the percentage of revenue remaining after all operating expenses, interest, taxes, and preferred stock dividends but not common stock dividends have been deducted from a company's total revenue (Eileen .T,2005). This ratio equates net income divided by net sales multiplied by 100 that is, if net income is $ 100,000 and net sales of $ 1,000,000, net profit margin will equal to 100,000 divided by 1,000,000 times 100, this will give 10 percent. This means that for every dollar the business makes in sales, a profit is earned in net income (Shawn, Grimsley, 2003).

Net profit margin is one of the most closely followed numbers in finance. Shareholders look at net profit margin closely because it shows how good a company is at converting revenue into profit available for shareholders,(Richard Loth, 2014).Changes in net profit margins are endlessly scrutinized, when a company's net profit margin is declining over time, a series of

problems could be to blame, ranging from decreasing sales to poor customer experience to inadequate expense management.

Karen .B, (2013), reveals that profitability is the most important measure of the firm's financial performance as it establishes the stewardship of the business and also assures a going concern, a business that is not profitable cannot survive, conversely one that is highly profitable has the ability to reward its owners with a large return on investment.

2.3.3 Solvency as a measure of financial resources.

Solvency is the ability of a business to meet his long term financial commitments. Solvency is essential to staying in business, it is the only one of the metrics used to determine whether a company can stay solvent (Jay Wagner, 2013). To establish a firm's solvency, given ratios are used that is debt to equity ratio, total debt to total assets and interest coverage ratio.

Solvency ratio also called leverage ratio, measure a company's ability to sustain operations indefinitely by comparing debt levels with equity, assets, and earnings. In other words solvency identify going concern issues and a firm's ability to pay its bills in a long term (Eileen .T, 2005).

Akhtar, 2005), establishes that solvency ratio is a comprehensive measure of solvency, as it measures cash flow rather than net income by including depreciation to assess a company's capacity to stay afloat. It measures this cash flow capacity in relation to all liabilities, rather than only debt.

Measuring cash flow rather than net income is a better determination of solvency especially for companies that incur large amounts of depreciation for their assets but have low levels of actual profitability (Richard Loth, 2014). Similarly, assessing a company's ability to meet all its

obligations rather than debt alone, provides a more accurate picture of solvency. A business may have a low debt but if its cash management practices are not poor and accounts payable is surging as a result, its solvency position may not be as solid as would be indicated by measures that include only debt (Eileen .T,2005).

Interest coverage ratio is a financial ratio to measure a company's ability to pay its interest on debt. The interest ratio is computed by dividing a corporation's annual income before interest and income tax expenses or its annual expenses (Akhtar, 2005). According to Richard Loth, (2014), a large coverage ratio indicates that a corporation will be able to pay the interest on its debt even if its earnings were decreasing while a smaller interest ratio sends a caution signal.

According to (Richard Loth, 2014), the interest coverage ratio measures how many times over a firm could pay its current interest payment with its available earnings. It measures the margin of safety a firm has for paying interest during a given period, which a firm needs in order to survive future and perhaps unforeseeable financial hardships when they arise. A firm's ability to meet its interest obligations is an aspect of a company's solvency.

Debt/Equity ratio is a debt ratio used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its shareholder's equity. The ratio indicates how much debt a company is using to finance its assets relative to the amount of value represented in shareholder's equity (Eileen .T,2005).

This ratio can be applied to personal financial statements as well as corporate ones, in this case it is known as personal debt/equity ratio. Here equity refers not to the value of shareholder's shares but rather to the difference between total value of a corporation or individual's assets and that corporation or individual's liabilities (Richard Loth, 2014).

Given that the debt/equity ratio measures a company's debt relative to the total value of its stock, it is most often used to gauge the extent to which a company is taking on debts as a means of leveraging. A higher debt/equity ratio generally means that a firm has been aggressive in financing its growth with debt. Aggressive leveraging practices are often associated with high levels of risk, this may result in volatile earnings as a result of additional interest expense (Phil Mitchel, 2015).

Like with most ratios, when using debt/equity ratio it is very important to consider the industry with which the firm is operating in.

2.4 Actual Review of literature

2.4.1 Relationship between Debt financing and financial performance.

Debt financing refers to that amount of capital raised by taking a loan. It is a strategy that involves borrowing from a lender or investor with the understanding that full amount will be repaid in the future usually with interest (David L. 2003).

Potts and Jason, (2007), establish that debt financing can be long term or short term. Short term debt financing includes debt securities with short redemption periods and used to provide day to day necessities such as inventories and payroll. Long term debt financing usually involves a business need to buy the basic necessities for its business such as facilities and major assets.

Cecchetti et al, (2011), establishes that moderate debt levels improves welfare of the business and enhances growth. The more the debt keeps in the business the more it can be put to use and hence availing the business with enough capital to run its operations a moderate level of debt increases the firm's liquidity and profitability thus a better financial performance.

The nature of debt is an important determinant of productivity of a firm. The availability of long term debt finance, it can invest in new capital and equipment which helps to increase productivity and profitability of the firm Marcouse et al, 2003. The in ability to access long term finance can force firms to use short term debt to finance long term projects. This will create a mismatch of assets and liabilities and depletes working capital. This will negatively affect the firm's operations hence poor financial performance (Venture et al, 2004).

Debt financing allows payment for new buildings, equipment and other assets used to grow the business before it can be in position to earn necessary funds. With low interest rates, debt can be a more aggressive growth strategy for the business and with paying in instalments the business is able to finance its operations and also pay off its debts hence a positive relationship between debt and financial performance (Richard Loth, 2014).

A high proportion of debt in the business will harm investment; debt ratio has a negative impact on fixed investments (Cecchetti et al, 2011). A firm with high debt ratio will channel most of its income to debt repayments thereby forgoing investment. As more debt is employed in the capital structure of a firm, the business risk also increases.

Matvos (2013), stated that leveraging may increase the risk of bankruptcy and financial distress during temporary industry and economy wide downturns. High debt leverage may lead to high interest charges hence affecting the firm's profits thus poor financial performance.

Most lenders provide severe payments for late or missed payments which include charging late fees, taking the possession of collateral payments on a loan failure to pay credit can affect small business' credit rating (Ocansey, 2006).

Overall debt financing can be a valuable option for SMEs that require cash to begin or expand their operations but experts warn that carrying too much debt can cause a firm to encounter severe cash flow problems, instead it's better to use a combination of different forms of financing in order to spread the risk and facilitate future funding effort (Richard .L, 2000).

2.4.2 Relationship between Equity financing and financial performance.

According to David L and Scot, (2001), equity financing involves the sale of the company's stock and giving a portion of ownership of the company to investors in exchange for cash. The proportion of the company that will be sold in an equity financing depends on how much the owner has invested in the business and what that investment is worth at the time of financing.

Equity financing is a method of raising capital for the business before it is profitable enough in exchange for diluted ownership and general control of the business. This method of financing is important in a way that it ensures the business with capital to run its operations like purchasing the required goods, this means the business will be in position to improve its financial performance as it will be in position to meet its customer's needs. However if the business does not have capital, its finance position and performance is affected in a way that it will not be in position to meet its operations (Atieno, 2006).

Equity financing is important to businesses as it can be used to finance expansion, selling shares to investors for cash assures business growth as they invest in funds that facilitate business operations and pay for their debts when they fall due hence a great relationship between financial performance and the method of funding as increase in growth of the business through equity funds is also an indicator that the business is operating at a break even, financing its activities and paying for debts without borrowing (Njeru et al, (2012).

According to Jay Wagner, (2013), equity financing is as necessary to a business as air is to a person but because it comes in several forms, it can easily be misunderstood. Equity allows you to stay out of debt, but gives up a percentage of the business and profits to an investor (Clifford .C, 2014). Michel Lebas, (2006), reveals that equity financing can sometimes prove to be more appropriate than other sources of finance, that is bank loans as there is no worries that a given percentage of profits will be paid back as repayment of debt but rather retained as working capital or invested into other operations hence improving the financial performance of the business.

There are several forms of equity that SMEs take up to finance their businesses including personal savings, venture capital, business angels and employee share benefit. Each one of these forms of equity financing pose a relationship with financial performance (Kasekende, L.A, 2001). The finances obtained come with no security or collateral to pay in order to get them meaning easy access to funds to meet the business operations thus boosting the financial performance compared to other forms of funding (Atieno, 2006).

Equity financing avails control to the business owners, as the owner invests in the business money in form of equity say personal savings, he gets total control for the business as there is no stress that failure to pay back the money, possession may be transferred to some other owner, this control enables the owner to make good management decisions that while help in the growth of the business, like where to source more finance say ploughing back of profits in the business, which increases capital hence better financial performance (Njeru et al, (2012).

2.2.3 Relationship between Retained earnings and financial performance.

Retained earnings means that part of trading profit which is not distributed in the form of dividends but retained by directors for future expansion of the business (Karen .B, 2013). Retained earnings ultimately come back to the equity shares in the form of enhanced dividend or capital gains.

Retained earnings are one important source of internal financing used for fixed as well as working capital (Phil Mitchel, 2015). This helps the business to use the gained working capital in the business operations like paying debts, acquisition of goods which in turn meaning good financial position (Kasekende, L.A, 2001).

According to (Michel Lebas, 2006), retained earnings is an internal source of finance available to the company, due its availability, ensures steady supply of finance to the business hence being in position to take up new growth opportunities like buying new assets and expenses for research and development, a business that purchases new assets and invests in research, means its operating at a break even hence a better financial performance.

Retained earnings do not involve any explicit costs in the form of interest, dividend or flotation cost making it a better option for funding to SMEs. According to Carter, Michael, (2004), as funds are generated internally, there is a greater degree of operational freedom and flexibility thus stable investment operations. This source of finance strengthens the financial position of a business and therefore gives financial stability to the business.

Retained earnings increases the supply of cash that's available for acquisitions, repurchase of outstanding shares, or other expenditures this implies a given level of liquidity. Retained earnings are viewed as a favourable internal source of finance because of, ready availability,

cheaper than external equity, no ownership dilution and positive connotation (Kasekende, L.A, 2001). Being an internal source is readily available to management and directors do not have to ask outsiders for finance.

This form of finance is cheaper than external equity because the flotation costs, brokerage cost, underwriting commission and other issue expenses are eliminated (Glyn Davies, 2002) hence all profits earned are ploughed back in the business thus better financing.

Given retained earnings, there is no ownership dilution relying on them which eliminates fear of ownership being diluted between the owner and the external investors of equity and loss of control to existing shareholders and easy management and planning for the business.

However limited funds are realised with retained earnings, keeping in view, a stable dividend policy, the director cannot exhaust the whole balance retained (Brown et al, 2010).

David L and Scot, (2001), reveals that, use of retained earnings should be accompanied with other funding sources as excessive ploughing back of profits may cause dissatisfaction amongst the shareholders as they could get lower dividends.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This chapter is going to concentrate on the methodology the researcher used when carrying out the research. It examined the: research design, study population, area of study, sample size and selection, sampling techniques, methods of data collection, data management and analysis, data reliability and validity, limitations and the ethical considerations the study respected.

3.2 Research design

The researcher used a case study design. The design was used because it gives an in-depth study of a particular research unit rather than a trivial statistical survey. The design also allows the researcher to comprehensively and intensively study only one small and medium enterprise; African Queen Limited.

Both qualitative and quantitative data approaches were used by the researcher. Quantitative approach was used because it helps in the reporting of summary results in numerical terms and qualitative approach because it examines the why and how of decision making and produces information only to particular cases studied, also provides totality understanding of the studied situation.

3.3 Area of study

The study was carried out at African Queen Headquarters in Mukono - Namave off the Kampala-Jinja highway and Kampala branch of Kikuubo found in down town Kampala opposite old taxi park on giant plaza. African Queen’s headquarters in Namanve and the Kampala branch Kikuubo down town have a considerably big number of administrative staff, (38).

3.4 Study population

The researcher's study population was the administrative staff at the headquarters and at the branch in Kampala – Kikuubo. Administrative staff at African Queen Headquarters and Kikuubowas (38) in number including the executive director, the managing director, operations managers, finance administrators, human resource managers, and record officers. The study population was presumed to have the required information and therefore in position to give the required information for the completion of the research study.

3.5 Sample size and selection

The total size of the study's population was (38). Top managers including (1) Executive director, (1) Managing director, (12) operations managers, (9) finance administrators, (9) record officers, (6) human resource managers. Out of the thirty eight employees (38), the researcher selected thirty five (35). For sampling Krejcie and Morgan, as cited by (Amin, 2005, p454), recommend this type of selection.

Table 3.1: Category of sample size

s/n	Type of Employees	Total number of employees	Sample size
1	Top Managers	2	2
2	Operations managers	12	10
3	Human resource managers	6	5
4	Record officers	9	9
5	Finance administrators	9	9
6	Total	38	35

3.5.2 Sampling technique

The researcher used purposive sampling by sampling administrative (skilled) employees that have worked with African Queen Limited for at least three (3) years. These officers were assumed to be well knowledgeable about the financial performance of African Queen. Probability sampling was also used by asking every active employ at the branch to at least give their view on the financial performance of the business.

3.6 Data collection sources

The researcher used both primary and secondary sources of data. Primary data sources included questionnaire and interview guide, secondary data sources included the review of the necessary documentation on the company's financial performance.

3.7 Data collection tools

Questionnaires were used since they are easier and cheaper tool of data collection. The researcher used questionnaires to allow respondents give feedback at their convenience and anonymity (Amin 2005, p271). One questionnaire was designed with both open ended and closed questions. The questionnaires were given to operations managers, human resource managers, records officers and finance administrators.

Interviews were used to find out how employees carry out the analysis of financial performance of the business and challenges that the entire organisation is facing in the achievement of the intended financial performance. The study interviewed the two top managers of African Queen this is because these parties are more knowledgeable about the funding and financial performance of the organisation hence more information will be provided to the researcher.

3.7 Quality Control

3.7.1 Validity

Validity was ensured by requesting the supervisor to go through the questionnaires in order to test for content validity which was computed using the following formula;

$$CVI = \frac{(19)}{(25)} \times 100 = 76\%$$

Content validity index gave a value of 76%.

3.7.2 Data reliability

The researcher ensured data reliability by pilot testing of questionnaires (on targeted but non sampled personnel).

The researcher also ensured precision and clarity of instructions in questionnaires. Additionally SPSS was used to compute the alpha value which indicates whether the total is valid or not. According to Sekaran (2003) a research tool is considered to be reliable when the alpha value is above 0.6.

3.8Data management and Analysis

3.8.1 Quantitative data

After collecting the completed questionnaires the researcher coded while using SPSS and then analysed and presented the data using graphs, pie charts and frequency tables. The effect between the independent and dependent variables was ascertained using correlation analysis.

3.8.2Qualitative data

Thematic analysis was used to summarise the information from questionnaires and interview guides. Thematic analysis is the systematic identification and isolation of the major ideas, topics (themes) and patterns that emerge from respondents' answers (Gray 1996; Kombo et al, 2006).

3.9 Ethical consideration

The researcher asked for permission from the branch manager African Queen Limited Kampala – Kikuubo and that of the headquarters before carrying out the study in the organisation.

The researcher did not pressurise the staff of African Queen when acquiring data.

The researcher assured the staff of confidentiality of their data and that it was to be used strictly for academic purposes.

3.10 Limitation to the study

Time was a great factor that limited the study as some of the targeted respondents failed to have the required time to answer the questions and availing the researcher with the required information. As a control of many failures, the researcher used to make constant visits to the headquarters in Mukono and the branch in Kampala as a way of reminding them about the exercise so as to reduce of the rate of delays brought about by lack of time.

The researcher failed to acquire the targeted range of information due to the fact that some respondents failed to respond properly to the set questions in the questionnaire. As a way of resolving the issue, the researcher did set questions in the simplest form possible so as to avoid failure of understanding the questions which limits the information which would have been obtained.

Attitude towards the whole process of the research by the targeted respondents, having negative attitude the process did not go smoothly as expected and limited the acquiring of enough information. This was somehow resolved by explaining to the study population that the exercise is purely academic and nothing said was to be held against them.

3.11 Conclusion

The chapter looked at the methodology that was used by the researcher when carrying out the research.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND DISCUSSION

4.0 Introduction

This chapter presents the data that was collected from the field. This data is analyzed and presented in different forms.

4.1 Response rate

A total of 35 questionnaires were distributed to the respondents and 33 were received back. This resulted into a response rate of 94.2%.

4.2 Bio data

Respondents were required to give details of their gender, age bracket and duration they have worked with the organization. The following were the findings;

4.2.1 Gender of respondents

The details of the gender of the respondents were as follow;

Table 4.1: Gender of respondents

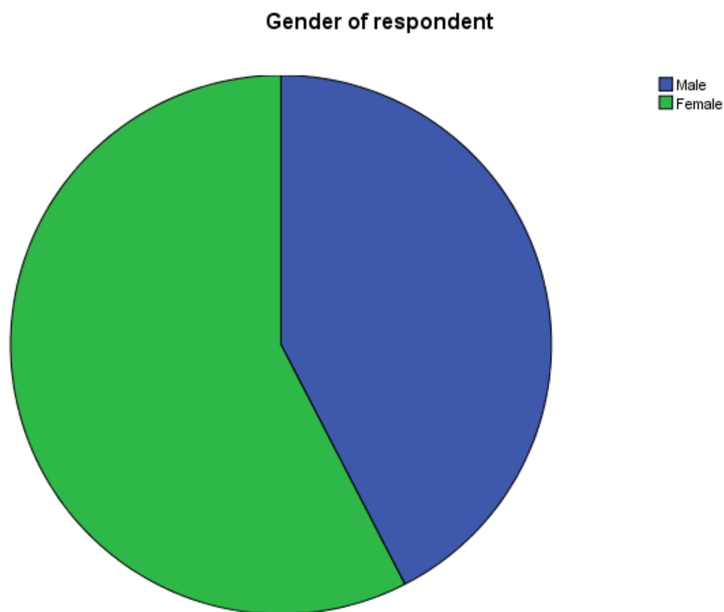
Gender of respondent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	14	42.4	42.4	42.4
	Female	19	57.6	57.6	100.0
	Total	33	100.0	100.0	

From the table above, data collected from the field indicated that 42.4% of the respondents were male while 57.6% were female. This implies that African Queen employs more females than

male employees due to the fact that it distributes mainly consumables used by females. This data can also be represented graphically as shown below;

Figure 2: Gender of Respondents



4.2.2 Age bracket of respondents

The details of the age bracket of the respondents were as follows;

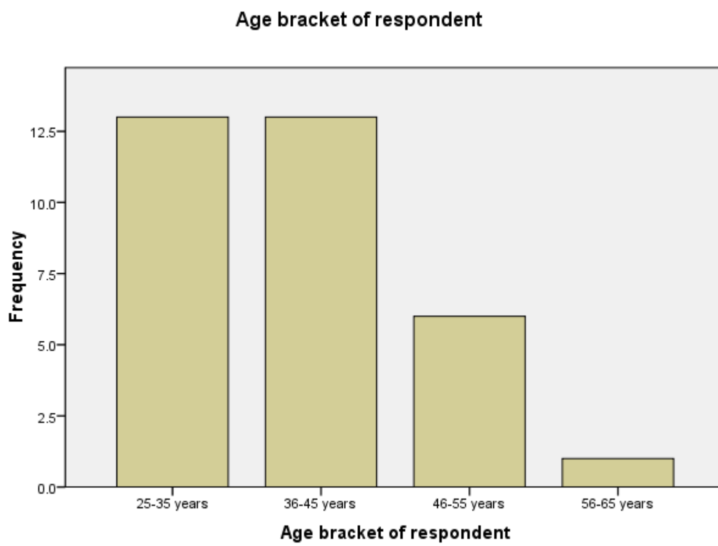
Table 4.2: Age bracket of respondents

Age bracket of respondent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	25-35 years	13	39.4	39.4	39.4
	36-45 years	13	39.4	39.4	78.8
	46-55 years	6	18.2	18.2	97.0
	56-65 years	1	3.0	3.0	100.0
	Total	33	100.0	100.0	

From the table above, data collected from the field indicated that 39.4% of the respondents were between the ages of 25-35 years, 39.4% were between 36-45years, 18.2% were between 46-55 years and 3.0% were between 56-65years. This implies that African Queen employs more youth than the elderly due to the fact that the youth are knowledgeable about the changes in technology and trends. This data can also be represented graphically as below;

Figure 3: Age bracket of respondents



4.2.3 Duration of service with the company

The details of the duration of service with the company of the respondents were as follow;

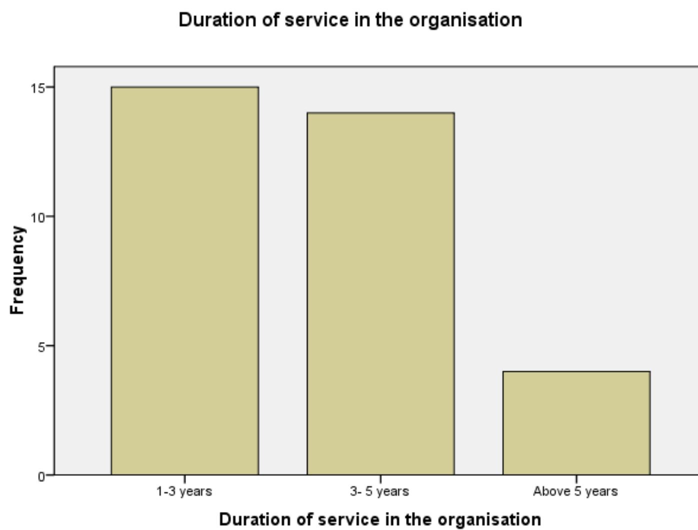
Table 4.3: Duration of service

Duration of service in the organisation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1-3 years	15	45.5	45.5	45.5
	3- 5 years	14	42.4	42.4	87.9
	Above 5 years	4	12.1	12.1	100.0
	Total	33	100.0	100.0	

From the table above, data collected from the field indicated that 45.5% of the respondents had stayed with the companybetween 1-3years, 42.4% were between 3-5years, and 12.1% were above 5 years. This implies that most of the employees at the company are still new.

Figure 4: Duration of Service with the company



4.3 Descriptive statistics on Debt financing

The following are the descriptive statistics on debt financing analyzed from the data collected from the field;

Table 4.4: Descriptive Statistics on Debt Financing

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
We borrow as a source of financing	33	1.00	5.00	4.0303	1.04537
The interest charged on the acquired debt by the company is manageable	33	2.00	5.00	4.0303	.68396
The company has to have collateral security when assessing loans.	33	2.00	5.00	4.1515	.66714
Debt financing is a valuable option for SMEs that require cash to begin or expand their operations	33	1.00	5.00	3.4848	.90558
The longer the debt stays in the business the more risk is the business to lose its ownership due to repayment failure	33	2.00	5.00	3.9091	.87905
Valid N (listwise)	33				

Source of financing.

From the table above, respondents were required to indicate if they borrowed as a source of financing. Results showed a mean of 4.03 which implies that the majority agreed to this statement. A standard deviation of 1.04 was shown which implied that respondents had varying

views on this issue. Additionally respondents mentioned that bureaucratic procedures involved in accessing the loan make it a bit tight to acquire the debt.

Manageable interest charged

On the statement whether the interest charged on debt was manageable, the mean was 4.03 which implied that majority of the respondents agreed to this statement. A standard deviation of 0.68 implies that the views of the respondents also varied from one respondent to another. . Additionally respondents mentioned that high risk of losing collateral which was used as security to acquire the loan limits the company in acquiring access debt to finance its activities. Respondents revealed that when a debt stays long in the business it can bring about high rates of cash out flow due to payment terms, that is delayed payment, increased interest to pay.

Collateral security on loans

The statement of the need for collateral security when acquiring loans provided a mean, 4.15 which indicated that many of the respondents agreed to the statement. A standard deviation of 0.66 implies that the views of the respondents varied from different respondents. Additionally the research established that in order to access the loans, there must be collateral security yet at times it might not be available.

Debt financing valuable for SMEs

This statement stated that debt financing is a valuable option for SMEs that require cash to begin or expand their operations. The mean was 3.48 which indicated that majority of the respondents were not sure about the statement, giving a standard deviation of 0.9 which imply that the views varied.Respondents from the study revealed that debt is available to late stage grown companies and this limits easy access to loans to finance their business operations.

Long debt in business is more risky to it.

The statement provided that the longer the debt stays in business the more risk is the business to lose its ownership due to repayment failure, mean was 3.9 which implied that most of the respondents were not sure about the statement. The standard deviation is 0.8 indicating that views varied from respondent to respondent**.** From the research conducted, respondents revealed that long term loan is risky to the business and failure to pay for it can bring about loss of property and the business as a whole.

4.4 Descriptive statistics on Equity Financing

The following are the descriptive statistics on Equity financing analysed from the data collected from the field;

Table 4.5: Descriptive Statistics on Equity Financing

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Equity financing is a method of raising the business before it is profitable enough	33	2.00	5.00	4.1515	.79535
Equity financing can attract capital for the business during its early stages when there is insufficient revenue, cash flow and hard assets to act as collateral for debt	33	2.00	5.00	3.8182	.72692
Equity financing sometimes proves to be more appropriate than other sources of finance such as debt.	33	1.00	5.00	3.6970	.91804
SMEs sales part ownership of their business to acquire finances for their business operations and boost their financial positions.	33	1.00	5.00	3.5758	.96922
Equity financing is the cheapest and easier way to provide funds to SMEs	33	2.00	5.00	3.6364	.89506
Valid N (listwise)	33				

Method of raising capital

The statement provided that equity financing is a method of raising the business before it is profitable enough. Mean was 4.1 which implied that most of the respondents agreedto the statement. The standard deviation is 0.7 indicating that views varied from respondent to respondent**.**According to the respondents the level of capital required to use in the business will determine the level of equity that will be invested.

Equity attracts capital for the business

On the statement whether equity financing can attract capital for the business during its early stages when there is insufficient revenue, cash flow and hard assets to act as collateral for debt, the mean was 3.8 which implied that most of the respondents were not sure of the statement however given 0.7 standard deviation indicated that they had different views given the same statement. Additionally respondents revealed that the percentage of ownership to give to the shareholders determines the level of capital the equity shareholders will be willing to invest in the business.

Equity more is appropriate

The statement whether equity financing sometimes proves to be more appropriate than other sources of finance such as debt. The mean was 3.6 which implied that most of the respondents were not sure of the statement however given 0.9 was the standard deviation and this indicated that they had different views on the same statement. From the study respondents established that how much money that the business needs determines the best source of funds, equity here is the best as it will not need repayment like it is with debt financing.

SMEs sale part of their business ownership

The statement provides that SMEs sales part ownership of their business to acquire finances for their business operations and boost their financial positions. The mean was 3.5 which implied that most of the respondents were not sure of the statement however given a standard deviation of 0.9 indicated that respondents had different views on the statement. Respondents from the study established that the degree of ownership that the business retains determines the degree of ownership of the company.

Equity is the cheapest source

From the table above, respondents were required to indicate if Equity financing is the cheapest and easier way to provide funds to SMEs. Results showed a mean of 3.6 which implies that the majority were not sure to this statement. A standard deviation of 0.8 was shown which implied that respondents had varying views on this issue. From the research it was revealed that equity financing is the cheapest form of funding as its management is easier than when it comes to other sources of financing.

4.5 Descriptive statistics on Retained Earnings

The following are the descriptive statistics on Retained Earnings analyzed from the data collected from the field;

Table 4.6: Descriptive Statistics on Retained Earnings

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Cheapest form of financing source but rather very insufficient for the run of the business operations.	33	1.00	5.00	3.7576	1.09059
Retained earnings are only available to the firm when it makes profits.	33	1.00	5.00	3.9697	.95147
Ploughing back of profits in the business operations strengthen the financial position of the business and therefore gives financial stability to the business.	33	1.00	5.00	3.7273	.76128
As part of internal sources of finance, retained earnings are readily available, cheaper than external equity and boost the business operations.	33	1.00	5.00	3.6667	.95743
The use of retained earnings should be accompanied with other funding sources to avoid excessive ploughing which strains the business capital.	33	1.00	5.00	3.7273	1.03901
Valid N (listwise)	33				

Retained earnings the cheapest form of financing source.

On the statement whether retained earnings are the cheapest form of financing source but rather very insufficient for the run of the business operations. The mean was 3.7 which implied that most of the respondents were not sure of the statement, 1.7 was the standard deviation which indicated that the respondents had different views.

Available when there are profits

The statement provides that retained earnings are only available to the firm when it makes profits. The mean was 3.9 which implied that most of the respondents were not sure of the statement however given a standard deviation of 0.9 indicated that respondents had different views on the statement.

Ploughing back of profits

The statement retained earnings are ploughed back in the business operations and strengthen the financial position of the business and therefore gives financial stability to the business. The mean was 3.7 which implied that most of the respondents were not sure of the statement, 1.0 was the standard deviation which indicated that the respondents had different views.

Internal source of finance

From the table above, respondents were required to indicate if, as part of internal sources of finance, retained earnings are readily available, cheaper than external equity and boost the business operations they borrowed as a source of financing. Results showed a mean of 3.6 which implies that the majority were not sure of the statement. A standard deviation of 0.9 was shown which implied that respondents had varying views on this issue.

Use accompanied with other sources.

From the table above, respondents were required to indicate if, the use of retained earnings should be accompanied with other funding sources to avoid excessive ploughing which strains the business capital. Results showed a mean of 3.7 which implies that the majority were not sure of the statement. A standard deviation of 1.0 was shown which implied that respondents had varying views on this issue.

4.6 Descriptive statistics on financial performance

The following are the descriptive statistics on financial performance analysed from the data collected from the field;

Table 4.7: Descriptive Statistics on Financial Performance

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Profitability determines whether a business stays in operations or not.	33	1.00	5.00	4.2121	.92728
The profits have grown over the years.	33	2.00	5.00	3.6364	.74239
The business sells more than in the past years. The operating expenses have reduced while maintaining sales revenue over the years.	33	2.00	5.00	3.6061	.60927
The business does not accumulate debts for longer than 12 months	33	2.00	5.00	3.2727	.67420
The business pays back its debt when they fall due.	33	2.00	5.00	3.5152	.75503
The payment terms negotiated with suppliers are favourable for business.	33	2.00	5.00	3.6061	.70442
The business clears all its long term debt with ease	33	1.00	5.00	3.4545	.83258
The repayment schedules are negotiated between creditors and business.	33	2.00	5.00	3.3636	.78335
The business makes long term investments to clear long term liabilities when they fall due.	33	2.00	5.00	3.6970	.76994
Valid N (listwise)	33				

Profitability determines business operations

The statement provides that profitability determines whether a business stays in operations or not. The mean was 4.2 which implied that most of the respondents agreed to the statement however given a standard deviation of 0.9 indicated that respondents had different views on the statement.

Profits have grown

The statement provides that profitability determines whether a business stays in operations or not. The mean was 3.6 which implied that most of the respondents were not sure of the statement however given a standard deviation of 0.7 indicated that respondents had different views on the statement.

The business sales more

The statement provides that the business sells more than in the past years. The operating expenses have reduced while maintaining sales revenue over the years. The mean was 3.6 which implied that most of the respondents were not sure of the statement however given a standard deviation of 0.6 indicated that respondents had different views on the statement.

Business does not accumulate debts

From the table above, respondents were required to indicate if, the business does not accumulate debts for longer than 12 months. Results showed a mean of 3.2 which implies that the majority were not sure of the statement. A standard deviation of 0.6 was shown which implied that respondents had varying views on this issue.

The business pays back its debt

The statement whether the business pays backs its debts when they fall due. The mean was 3.5 which indicated that they were not sure of the statement and standard deviation of 0.7 indicates that different views were given.

Payment terms

From the table above, respondents were required to indicate if, the payment terms negotiated with suppliers are favourable for business. Results showed a mean of 3.6 which implies that the majority were not sure of the statement. A standard deviation of 0.7 was shown which implied that respondents had varying views on this issue.

Business clears all long term debts

From the table above, respondents were required to indicate if, the business clears all its long term debt with ease.Results showed a mean of 3.4 which implies that the majority were not sure of the statement. A standard deviation of 0.8 was shown which implied that respondents had varying views on this issue.

Repayment schedules

From the table above, respondents were required to indicate if, the repayment schedules are negotiated between creditors and business. Results showed a mean of 3.3 which implies that the majority were not sure of the statement. A standard deviation of 0.7 was shown which implied that respondents had varying views on this issue.

Long term investments

From the table above, respondents were required to indicate if, the business makes long term investments to clear long term liabilities when they fall due. Results showed a mean of 3.6 which implies that the majority were not sure of the statement. A standard deviation of 0.7 was shown which implied that respondents had varying views on this issue

4.7 Correlation Analysis

To determine the relationship between the independent and dependent variables, correlation analysis was conducted for each one of the research specific objectives as shown below:

4.7.1 Correlation between Debt financing and financial performance

Table 4.8: Correlation analysis between debt financing and financial performance

Correlations

		Debt financing	Financial performance
Debt financing	Pearson Correlation	1	.542**
	Sig. (2-tailed)		.001
	N	33	33
Financial Performance	Pearson Correlation	.542**	1
	Sig. (2-tailed)	.001	
	N	33	33

**. Correlation is significant at the 0.01 level (2-tailed).

Correlation analysis conducted between Debt financing and Financial performance showed a result of ($r = 0.542$, $p<0.01$) which implies that there is a positive and significant effect between debt financing and financial performance. This means that a change in debt financing will cause

a 54.2% change in financial performance. This finding agrees with Cecchetti et al, (2011), who established that moderate debt levels improve welfare of the business and enhance growth. The more the debt keeps in the business the more it can be put to use and hence availing the business with enough capital to run its operations a moderate level of debt increases the firm's liquidity and profitability thus a better financial performance.

4.7.2 Correlation between Equity financing and financial performance

Table 4.9: Correlation analysis between equity financing and financial performance

Correlations

		Equity financing	Financial performance
Equity financing	Pearson Correlation	1	.518**
	Sig. (2-tailed)		.002
	N	33	33
Financial performance	Pearson Correlation	.518**	1
	Sig. (2-tailed)	.002	
	N	33	33

**. Correlation is significant at the 0.01 level (2-tailed).

Correlation analysis conducted between Equity financing and Financial performance showed a result of ($r = 0.518$, $p<0.01$) which implies that there is a positive and significant effect between equity financing and financial performance. This means that a change in equity financing will cause a 51.8% change in financial performance. This agrees with Jay Wagner, (2013), who revealed that equity financing is as necessary to a business as air is to a person but because it comes in several forms, it can easily be misunderstood which can lead to business issues or even failure.

4.7.3 Correlation between retained earnings and financial performance

Table 4.10: Correlation analysis between retained earnings and financial performance

Correlations

		Retained earnings	Financial performance
Retained earnings	Pearson Correlation	1	.554**
	Sig. (2-tailed)		.001
	N	33	33
Financial performance	Pearson Correlation	.554**	1
	Sig. (2-tailed)	.001	
	N	33	33

**. Correlation is significant at the 0.01 level (2-tailed).

Correlation analysis conducted between Retained earnings and Financial performance showed a result of ($r = 0.554$, $p<0.01$) which implies that there is a positive and significant effect between retained earnings and financial performance. This means that a change in Retained earnings will cause a 55.4% change in financial performance. This agrees with Carter, Michael, (2004), who established that retained earnings do not involve any explicit costs in the form of interest, dividend or flotation cost making it a better option for funding to SMEs. As funds are generated internally, there is a greater degree of operational freedom and flexibility. This source of finance strengthens the financial position of a business and therefore gives financial stability to the business.

4.8 Conclusion

In this chapter, the data collected from the field was presented and analyzed. Correlation analysis was conducted to determine the effect between the independent and dependent variables of this study.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter includes the summary of the main findings of main objectives of the research topic, the conclusion and the recommendations regarding the effect of funding sources on the financial performance of SMEs.

5.1 Summary of findings

Correlation analysis conducted between Debt financing and Financial performance showed a result of ($r = 0.542$, $p<0.01$) which implies that there is a positive and significant effect between debt financing and financial performance. This means that a change in the level of debt can bring about a positive or negative change in the financial performance of the company.

Correlation analysis conducted between Equity financing and Financial performance showed a result of ($r = 0.518$, $p<0.01$) which implies that there is a positive and significant effect between equity financing and financial performance. This implies that the more equity is employed in the company, the more profitable it can prove to be and the less this funding source is employed, the more it will affect the business negatively.

The research correlation study between retained earnings and financial performance of the business showed a result of ($r = 0.554$, $p<0.01$) which implies that there is a positive and significant effect between debt financing and financial performance. This means that a change in Retained earnings will cause a 55.4% change in financial performance thus the business financial performance will be boosted with moderate use of retained earnings being ploughed back in the business.

Based on these findings, the study accepted the hull hypothesis that funding sources have a positive and significant effect on SME performance.

5.2 Conclusions

From the study conducted, the following conclusions were made on the various sources of finance and the topic to the study.

Debt financing and Financial performance correlation conducted showed a result of ($r = 0.542$, $p<0.01$) which implies that there is a positive and significant effect between debt financing and financial performance. This means that increase in the level of debt will bring about increase in the financial performance of the business however excess use of debt may also impact the business negatively due to risks involved, and any decrease in the level of debt may affect the business' financial performance negatively hence debt financing has an impact on the financial performance of the business.

Equity financing and Financial performance showed a result of ($r = 0.518$, $p<0.01$) which implies that there is a positive and significant effect between equity financing and financial performance. Reducing the level of equity in the business could bring a negative impact on the business given the respondents reactions on the statements given to them and increasing equity in the business will cause a positive impact on the financial performance of the business thus an impact on the financial performance of the business.

Retained earnings and Financial performance showed a result of ($r = 0.554$, $p<0.01$) which implies that there is a positive and significant effect between retained earnings and financial performance. This means that the use of retained earnings to boost business operations is vital in the business operations, reduction in the use of the funding source may affect the business

negatively however excess ploughing is also a threat to the business and also failure to use them may affect the business negatively hence an impact on the financial performance of a business.

From the research conducted, various funding sources have an impact on the financial performance of small and medium enterprises. This is evidenced from the reactions from the respondents of the case study to the topic (African Queen limited), and various literatures obtained from several authors on the funding sources and financial performance and in all writing it's pretty evident that funding sources have an effect on the financial performance of small and medium enterprises.

5.3 Recommendations

From the research conducted on the effect of funding sources on the financial performance of SMEs, here are some of the recommendations;

Debt financing is a good funding source to be employed in the business however it is not good to go for it before the business is profitable enough and with enough assets to act as collateral security.

Before choosing debt, it's good for the business owners to first evaluate and establish how much money is needed for various business operations, if it is not that much then it's better to consider equity or retained because debt repayment involves interest that the business will have to pay which reduces on the business' returns.

Also debt should be employed when the business is going to operate on business activities that are expected to bring returns because debt comes with several repayments that may affect the business' net earnings hence affecting the financial performance of the business negatively.

Debt financing should be accompanied by other sources of finance to reduce to the several pay back payments involved with it. Other sources that don’t need pack back can help to run some operations as debt is also be used in other activities of the business.

Equity financing is the best source of finance that start up businesses should go for as there are no payments involved with it hence when one is preparing to start a business but with less capital, they should consider equity before they go for other funding sources.

It is also better to establish the level of business ownership the business owner would like to retain before it considers equity as there is loss of business ownership to the investors of the business hence before one takes in equity they should calculate the percentage they are willing to lose to the investors.

Ploughing back profits in the business, is the cheapest form of funding because it’s an internal source of capital that does not come with formalities and paper work to get it however when employing it in the business it has to be that time when the business has really made profits and only moderate earnings should be ploughed back as excess ploughing will affect the business’ solvency and liquidity levels.

5.4 Areas of further research

Several studies can be carried out in general on debt financing as a source of finance, Equity financing as a source of finance, retained earnings as a source of finance.

5.5 Conclusion.

The chapter summarised the findings of the effect of funding sources on the financial performance of SMEs, main objectives to the study, the conclusions on the topic and main objectives and the necessary recommendations.

APPENDIX

QUESTIONNAIRE

INTRODUCTION

I am NabalingaDorah, third year student Uganda Martyr's university Nkozi faculty of business administration and management. As part of the award of a Bachelor's Degree, I was tasked to make a study on the effect of funding sources on the financial performance of small and medium enterprises. Your organisation was chosen as a case study for the research. With Maximum Corporation with you, will assure the success of the task.

SECTION A: The respondent Bio data

Gender: Male ☐ Female ☐

Respondents age bracket.

25-33 ☐ 36-45 ☐ 46-55 ☐ 56-65 ☐

Duration of service with the company

1-3years ☐ 3-5years ☐ above 5 ☐

Scale for the questionnaire.

Strongly Agree	Agree	Not sure	Disagree	Strongly disagree
5	4	3	2	1

Section B: Debt financing as a source of finances.

Strongly Agree	Agree	Not sure	Disagree	Strongly disagree
5	4	3	2	1

	Statements	5	4	3	2	1
1	Debt financing is the major source of capital to SMEs since retained earnings seem insufficient to most them.					
2	The interest charged on the acquired debt by the company impact on the financial performance and company's operations.					
3	SMEs experience issues in accessing loans from financial institutions due to lack of collateral which acts as security.					
4	Debt financing is a valuable option for SMEs that require cash to begin or expand their operations.					
5	The longer the debt stays in the business the more risk is the business to lose its ownership due to repayment failure					

Section C: Equity financing as a funding source.

Strongly Agree	Agree	Not sure	Disagree	Strongly disagree
5	4	3	2	1

	Statements	5	4	3	2	1
1	Equity financing is a method of raising capital for the business before it is profitable enough in exchange for diluted ownership.					

2	Equity financing can attract capital for the business during its early stages when there is sufficient revenue, cash flow and hard assets to act collateral for debt.					
3	Equity financing sometimes proves to be more appropriate than other sources of finance such as debt.					
4	SMEs sales part ownership of their business to acquire finances for their business operations and boost their financial positions.					
5s	Equity financing is the cheapest and easier way to provide funds to SMEs as there are no collateral and formalities involved to access debt.					

Section D: Retained Earnings as a funding source.

Strongly Agree	**Agree**	**Not sure**	**Disagree**	**Strongly disagree**
5	**4**	**3**	**2**	**1**

	Statements	**5**	**4**	**3**	**2**	**1**
1	Cheapest form of financing source but rather very insufficient for the run the business operations.					
2	Retained earnings are always available to the firm but if they are ploughed carelessly they can negatively affect the financial performance of SMEs.					
3	Ploughing back of profits in business operations strengthen the financial position of the business and therefore gives financial stability to the business.					
4	As part of internal sources of finance, retained earnings are readily					

	available, cheaper than external equity and boost the business operations.					
5	The use of retained earnings should be accomplished with other funding sources to avoid excessive ploughing which strains the business capital.					

Section E: financial performance

Profitability as a measure of financial performance.

	Statement	**5**	**4**	**3**	**2**	**1**
1	Profitability determines whether a business stays in operation or not					
2	Measures the business' ability to generate revenue compared to the amount of expenses incurred.					
3	Firm's operating margins often determines how well it can satisfy creditors and create value for shareholders by generating cash flow.					

Liquidity as a measure of financial performance.

	Statement	**5**	**4**	**3**	**2**	**1**
1	The higher the current ratio, the more capable the business is of paying its obligations, as it has a larger proportion of asset value relative to the value of its liabilities.					
2	Liquidity measures the ease with which firms meet their financial obligations with liquid assets available.					
3	Liquidity is affected by several factors that affect business operation and					

	can overestimate the firm's liquidity.					

Solvency as a measure of financial performance.

	Statement	**5**	**4**	**3**	**2**	**1**
1	Solvency is essential to staying in business as it is the only metrics used to determine whether a firm is to stay in business or not.					
2	It also measures the firm's ability to sustain business operations indefinitely by comparing debt levels with equity.					
3	Measuring the cash flow rather than net income is a better determination of solvency especially for firms that incur large amounts of depreciation.					

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