

**CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF SELECTED
COMMERCIAL BANKS LISTED ON UGANDA
SECURITIES EXCHANGE**

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**A RESEARCH THESIS SUBMITTED TO THE COLLEGE OF ECONOMICS AND
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DECLARATION

I Ayebazibwe Wilbert, declare that this thesis is my original work and it has never been submitted to any university, or similar institution of higher learning, for the awarding of a degree, or any other academic award.

Signature: _____

Date: _____

APPROVAL SHEET

I confirm that the work reported in this thesis was carried out by the candidate under my supervision.

Signed: _____

Supervisor's Name: Dr. Byamukama Eliab

Date: _____

DEDICATION

I dedicate this research thesis to my wife, Orishaba Sheilah and my son; Agaba Oswin who gave me ample time to write this thesis.

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I thank the Almighty God for making it possible for me to complete this piece of work. Special thanks to Him for the knowledge, wisdom, courage and determination he has granted me always.

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LIST OF ACRONYMS AND ABBREVIATIONS

BoU	Bank of Uganda
DFCU	Development Finance Company of Uganda Limited
E.A.I.T	Earnings After Interest And Tax
EADB	East African Development Bank
KCB	Kenya Commercial bank limited
LTD _{i,t}	Long Term Debt
MFIs	Micro Finance Institutions
MM	Modigliani and Miller
N.I.I	Net Interest Income
RE _{i,t}	Retained Earnings
ROA	Return on assets
ROE	Return on equity
SC _{i,t}	Share Capital
SPSS	Statistical Package for Social Sciences
STD _{i,t}	Short Term Debt
USA	United States of America
USE	Uganda Securities Exchange
Ushs	Ugandan shillings
VIF	Variable inflation Factor

ABSTRACT

Capital structure and financial performance of selected commercial banks listed on Uganda Securities Exchange have received much attention in recent times, this is in light of realisation that what is now popularly referred to as capital structure. The study was based on the following four objectives; (i) to examine the effect of short term debt financing on the financial performance; (ii) to examine the effect of long term debt financing on the financial performance; (iii) to examine the effect of retained earnings on the financial performance; and (iv) to examine the effect of shareholders' capital on the financial performance of selected commercial banks listed on USE. The study employed longitudinal research design and methodology used was only quantitative. The study employed panel data of 5 commercial banks listed on USE over the period of 2010-2015. The findings revealed that; short term debt positively and insignificantly affects financial performance ($\beta=0.000$, $Sig=0.710$); long term debt financing positively and insignificantly affects financial performance ($\beta=0.001$, $Sig=0.523$); retained earnings are negatively and insignificantly related to financial performance ($\beta=-0.003$, $Sig=0.483$); and finally shareholder's capital is negatively and insignificantly related to financial performance of selected commercial banks listed on USE ($\beta=-0.001$, $Sig=0.128$). The study concluded that; short term debt has a positive insignificant effect on financial performance; long term debt financing has a positive insignificant effect on financial performance; retained earnings have a negative insignificant effect on financial performance; and shareholder's capital has a negative insignificant effect on financial performance of selected commercial banks listed on USE. The study recommended that; management of each commercial bank should consider the use of more short term debt and long term debt in their capital structure mix to increase their financial performance; should however, use less of retained earnings and share capital in financing their overall operations to increase their financial performance. Contribution of knowledge was gained from findings whereby other variables like bank size and growth opportunities contribute towards the financial performance of commercial banks, management have priorities set to meet their objectives and the study helped society on interpretation of figures of selected commercial banks.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

The background of the study is presented in historical, theoretical, conceptual and contextual perspectives in order to bring to light what is at hand.

1.1.1 Historical perspective

As commercial banks in developing countries strive to build their banking sector, lack of adequate capital in terms of debt and equity often impede their financial performance. Due to this constraint, commercial banks strive to ensure they combine available debt and equity in an optimal manner that can guarantee the maximization of financial performance. This suggests that capital structure can affect bank's financial performance. Capital structure decision is therefore vital one since the financial performance of a bank is directly affected by such decision.

Brounen and Eichholtz, (2001) depict that making a decision on the appropriate capital structure of an entity is among the most confusing aspects in the modern corporate finance. According to Pastory, Marobhe and Kaaya (2013), capital structure decision is crucial for any entity due to the fact that the stewards (managers) have a responsibility to make sure that the return to shareholders is maximized and because decisions of this nature have tremendous consequences on the ability of the entity to compete. Therefore, this decision on the ratio of total debt to equity is considered as a strategic one for managers i.e. future oriented and has a long term effect (Pastory, Marobhe and Kaaya, 2013).

Azhagaiah and Gavoury(2011) portray that the best alternative is a debt and equity mix. Owners would not be sure as to which source of financing to use if interest was not tax deductible. However, if interest was tax deductible, then managers would maximize the firm's financial performance by using debt financing only. But this is not possible due to the fact that debt finance increases the potential bankruptcy

costs and agency costs i.e. costs which arise due to the relationships between shareholders and managers, and those between debt-holders and shareholders.

Goyal (2013) narrated that the choice of financing is a reflection of an effort by corporate managers to make sure that there is a balance between tax shield of higher debt and the potential high cost of financial distress caused by under investment. The use of more debt is likely to destroy firm's value, because it results in financial distress and under investment however, the use of less debt may also destroy firm's value due to overinvestment which may affect profits.

Flannery and Rangan (2008) document that in the 1990s, large banks in the United States increased their capital well above the regulatory minimum. It is widely assumed in the banking literature that equity is a costly form of finance for banks and other financial institutions (Flannery and Rangan, 2008). This suggests that banks should minimize the amount of capital they use, and if there is a regulatory minimum, this should be binding. However, in practice, this is not the case.

Berger and Udell (2006), using data on commercial banks in the USA found that higher leverage or lower equity capital ratio is related to higher financial performance. At some point where bankruptcy and distress become more likely, the agency costs of outside debt overwhelm the agency cost of outside equity, and therefore further increases in leverage lead to higher total agency cost of outside debt from risk shifting or reduced effort to control risk that result in low financial performance.

According to Kyereboah and Coleman (2007) agency costs due to conflict of interest between shareholders and management lead to higher interest expenses from firms to be able to compensate debt holders for their expected losses. Thus, capital structure which is defined as total debt to total assets at book value, impacts on both the profitability and riskiness of a firm. Therefore, the structure of a firm's capital has implications for its operations and affects its financial performance. Awunyo-Vitor and Badu (2012) made an observation that the average capital structure of the listed Banks on the Ghana Stock exchange was 87% from 2000 to

2010 implying the banks listed on the Exchange are highly geared. The high level of gearing observed was that the banks financial performance can be attributed to their over dependency on short term debt.

According to Karani (2015) the financing or capital structure decision is a significant managerial decision, as it influences the shareholder return and risk. The market share also is affected by the capital structure decision. However, whether the funds have to be raised, a capital structure decision is involved.

According to Sekabira (2013) capital structure decision havea substantial damage consequence on a firm's financial performance due tooverdependence on debts. A great dilemma for management and bank shareholders alike is whether there exists an optimal capital structure. Hence, proper care and attention has to be paid as far as the effect of capital structure is concerned with financial performance, companies may fail to economize the use of their funds.

Commercial banking in Uganda started before Uganda's independence in 1962, where government-owned institutions dominated most banking in Uganda. In 1966, the Bank of Uganda (BoU), which controlled the issue of currency and managed foreign exchange reserves, became the central bank and national banking regulator. Uganda Commercial Bank, which had fifty branches throughout the country, dominated commercial banking and was wholly owned by the government (Uganda Banking, 2014). In the 1960s, other commercial banks included local operations of the Bank of Baroda, Barclays Bank, the Bank of India, Grindlays Bank, Standard Chartered Bank, and the Uganda Cooperative Bank. During the 1970s and early 1980s, the number of commercial bank branches and services contracted significantly (Uganda Banking, 2014).

In the late 1990s and early 2000s, the Ugandan banking industry underwent significant restructuring. Several indigenous commercial banks were declared insolvent, taken over by the central bank, and eventually sold or liquidated. These included the Uganda Cooperative Bank, Greenland Bank, the International Credit Bank, Teefe Bank, Nile bank and Gold Trust Bank (Juuko, 2007).

In October 2010, there were 22 licensed commercial banks in Uganda, with nearly 400 bank branches and almost 600 automated teller machines(Khisa, 2011). Among these 22 licensed commercial banks, five are listed on Uganda Securities Exchange as of September 2015(Uganda Securities Exchange, 2015).

The Uganda Securities Exchange (USE) is the principal stock exchange of Uganda. It was founded in June 1997. The USE is operating under the jurisdiction of Uganda's Capital Markets Authority, which in turn reports to the Bank of Uganda, Uganda's central bank(Onegi-Obel, 2016).

The exchange opened to trading in January 1998. At that time, the exchange had just one listing, a bond issued by the East African Development Bank. Trading was limited to only a handful of trades per week (Anyanzwa, 2016).

As of September 2015, the USE traded 16 listed local and East African companies as shown in table 1.1 below;

Table 1.1: Companies listed on Uganda's securities exchange

No.	Symbol	Company	Notes
1.	BOBU	Bank of Baroda (Uganda)	Finance, banking
2.	BATU	British American Tobacco	Tobacco products
3.	DFCU	DFCU Group	Finance, banking
4.	EABL	East African Breweries	Brewing, gin, distilled beverages
5.	JHL	Jubilee Holdings	Insurance
6.	KA	Kenya Airways	Aviation
7.	KCB	KCB Group	Finance, banking
8.	NVL	New Vision Group	Printing, publishing, broadcasting, television
9.	SBU	Stanbic Bank Uganda Limited	Finance, banking
10.	UCL	Uganda Clays Limited	Manufacturing, construction materials
11.	EBL	Equity Group Holdings	Banking, finance

		Limited	
12.	NIC	National Insurance Corporation	Insurance
13.	UCHM	Uchumi Supermarkets	Supermarkets
14.	NMG	Nation Media Group	Publishing, printing, broadcasting, television
15.	CENT	Centum Investments	Investments, private equity, real estate
16.	UMEME	Umeme	Power distribution

Source: Retrieved from Uganda Securities Exchange, 2015

1.1.2 Theoretical perspective

This study was underpinned by capital structure theories of irrelevance (Modigliani and Miller, 1958), relevance (Modigliani and Miller, 1963), agency (Jensen and Meckling, 1976), trade off (Kraus and Litzenberger, 1973) and pecking order (Donaldson, 1961). According to Modigliani and Miller capital structure irrelevance theory which was advanced by Modigliani and Miller (1958) who posited that without taxes and under assumptions of perfect markets, with no capital market frictions (i.e. no transaction costs, asset trade restrictions or bankruptcy costs), symmetric access to credit markets (commercial banks and investors can borrow or lend at the same rate and commercial bank's financial policy reveals no information), each commercial belongs to a risk class set with common earnings, a commercial bank's debt-equity ratio does not affect its financial performance. Therefore, the value of the levered commercial bank is equal to the value of unlevered commercial bank and hence capital structure financing decision is therefore irrelevant for its financial performance.

Modigliani and Miller (1958) argued that if two commercial banks are identical in all respects but only differ in their values of financial performance and in the way that they are financed, investors will sell shares of the overvalued commercial bank, buy shares of the undervalued commercial bank and continue this process until the two commercial banks command the same value of financial performance through a

process referred to as arbitrage. In essence, Modigliani and Miller (1958) theorized that a commercial bank with a particular set of expected cash flows simply divides them up among investors according to the proportion of debt and equity it uses to finance its assets (Luigi and Sorin, 2009). Dividing up those cash flows among investors has no effect on the commercial bank's financial performance (Brigham and Ehrhardt, 2010).

According to Modigliani and Miller (1958), the cost of equity of a levered commercial bank is equal to the cost of equity of an unlevered commercial bank plus a financial risk premium and hence it's cost to keep the financial performance of the commercial bank remains constant.

However, capital structure relevance theory proposed by Modigliani and Miller (1963) incorporated taxes by modifying their irrelevance theory and argued that capital structure of commercial banks indeed matters in determining their financial performance. The theory was based on the fact that in many jurisdictions; interest on debt is an allowable expense hence shield commercial banks from taxes and this increases their financial performance. Based on this assertion, commercial banks could borrow up to a 100% to reduce their taxes to zero if possible to effect a higher value of financial performance.

Jensen and Meckling (1976) argue that an optimal capital structure is attainable by reducing the costs resulting from the conflicts between commercial bank's managers, owners and debt holders in determination of financial performance. Jensen and Meckling (1976) argued that debt can be used by commercial banks to control the managers' behaviour by reducing the free cash flows within the bank by ensuring prompt payment of interest payments to determine their financial performance. This minimizes the cash at the disposal of managers likely to be misappropriated through personal interests or still waste the cash in organizational inefficiencies at the expense of the bank's objectives which results in increased financial performance.

According to Kraus and Litzenberger (1973), the commercial bank's optimal capital structure results from the trade off from the influences of banks and personal taxes, agency and bankruptcy costs. Commercial banks must therefore, choose the level of debt that maximizes their financial performance from the tax shield. It is anchored on the idea that commercial bank chooses how much debt finance and how much equity finance it should use by balancing the costs and the benefits.

According to De Miguel and Pindado (2001) the pecking order theory was first suggested by Donaldson in 1961 and further developed by Myers and Majluf (1984). It argues that commercial banks have a preferred hierarchy for financing decisions with the highest preference being to use internal financing before resorting to any form of external funds. This is because internal funds of commercial banks incur no flotation costs and require no additional disclosure of financial information that may lead to low financial performance (Mwangi, 2016). Castro, Tascón and Amor-Tapia (2012) also contend that this hierarchy is necessary in order to minimize commercial bank's adverse selection costs of security issuance as a result of the existence of asymmetric information.

1.1.3 Conceptual perspective

Moyer *et al.*, (1999) defines capital structure as how a firm finances its assets with permanent short term debt, long term debt, preferred stock and common equity. In general, firms finance only a part of their assets with equity (ordinary, preference and retained earnings) capital, while the other part is financed by other resources such as long term financial debt or liabilities (like bonds, bank loans and other loans) and other short term liabilities for example trade payables (Moyer *et. al.*, 1999). According to Fan, Titman and Twite (2012) capital structure is defined as owners' equity and interestbearing debt including short term bank loans.

According to Abor (2005), capital structure is the mix of debt and equity that the firm uses in its operation and is a mixture of different securities. Dare and Sola (2010) refer to capital structure as the debt-equity mix of business finance which is

used to represent the proportionate effect of debt and equity in corporate firms' finances.

Operationally, capital structure of commercial banks included debt and equity. Debt included short term debt and long term debt. On the other hand, equity included retained earnings and share capital.

Financial performance is the process of measuring the results of a firm's policies and operations in monetary terms (Erasmus, 2008). Metcalf and Titard (1976) defined financial performance as the act of performing financial activity in order to achieve financial objectives over a specific period of time. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation by using ratios which are used as a benchmark for evaluating financial performance of a firm and help to summarize large quantities of financial data and to make qualitative judgments about the firm's financial performance. According to Tharmila and Arulvel (2013), the benchmark of measuring financial performance of a firm is through return on equity and return on assets. According to Erasmus (2008), profitability, return on equity and liquidity ratios among others provide valuable tools or measures to stakeholders to evaluate the past and current financial performance of a firm.

Operationally, financial performance is the process of measuring the results of a firm's policies and operations in monetary terms which considered profitability.

1.1.4 Contextual perspective

Although banks are different from other corporate entities, they are still faced with the similar challenge of choosing the optimal capital structure that would minimize the cost of capital and increase profits as in non-financial entities. However, it is apparent from the existing literature that many surveys are either deficient of adequate variables or the scope of study is wanting. According to surveys of Shivdasani and Zenner (2005), Kaumbuthu (2011), Shubita and Alsawalhal (2012), Yusuf *et al.*, (2014), Chisti *et al.*, (2013), Zurigat (2009), Maina and Kodongo (2013)

and Chechet and Olayiwola (2014) did not split debt into short and long term in their analysis. It would have been imperative to split debt since there is a possibility that the two contributes differently to their response variable proxies. It is also evident in all surveys that equity capital has not been separated so as to analyse in isolation the impact of retained earnings, ordinary and preference capital on financial performance. In Uganda, few studies were conducted on capital structure. These were in microfinance institutions (Sekabira, 2013), electricity generation projects (Mutuyaba, 2014) but none was conducted in commercial banks. In view of the foregoing, this study therefore tried to address some of this deficiencies.

1.2 Statement of the problem

Despite the implementation of capital structure by commercial banks listed on USE, their financial performance is still poor (Frederick, 2015). These listed commercial banks finance their overall operations and growth by using different sources of funds such as long term debt, short term debt, retained earnings, ordinary shares and preference share capital as their capital structure (Frederick, 2015). However, these sources have ultimately produced low profitability of Ushs 188.2 billion, (Mukwanason and Ddumba-Ssentamu, 2016 and Bank of Uganda, 2016).

Commercial banks have continuously produced low profitability due to issues such as money laundering, poor managerial and accounting skills and bribery and corruption while financing their overall operations that reduces the returns (Sekabira, 2013) while maximizing overall cost of capital due to high debt acquired in an attempt to solve the challenge (Sejjaka, 2015).

Consequently, as a result of inefficient capital structure, some commercial banks have closed their businesses due to financial distress and (or) taken over by other commercial banks under the instructions of Central Bank of Uganda (Musa, 2014; Rupiny, 2012 and Bank of Uganda, 2016). It is upon this that the researcher is prompted to conduct a study on capital structure and financial performance of commercial banks listed on Uganda Securities Exchange.

1.3 Purpose of the study

The purpose of the study was to establish the relationship between capital structure and financial performance of selected commercial banks listed on Uganda Securities Exchange.

1.4 Research objectives

The objectives of the study were;

- (i) To examine the effect of short term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange.
- (ii) To examine the effect of long term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange.
- (iii) To examine the effect of retained earnings on the financial performance of selected commercial banks listed on Uganda Securities Exchange.
- (iv) To examine the effect of shareholders' capital on the financial performance of selected commercial banks listed on Uganda Securities Exchange.

1.5 Research questions

The study was guided by the following research questions;

- (i) What is the effect of short term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange?
- (ii) What is the effect of long term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange?
- (iii) What is the effect of retained earnings on the financial performance of selected commercial banks listed on Uganda Securities Exchange?
- (iv) What is the effect of shareholders' capital on the financial performance of selected commercial banks listed on Uganda Securities Exchange?

1.6 Research hypothesis

The study was guided by the following research hypotheses;

Ho₁: There is no significant relationship between short term debt financing and financial performance of selected commercial banks listed on Uganda Securities Exchange.

Ho₂: There is no significant relationship between long term debt financing and financial performance of selected commercial banks listed on Uganda Securities Exchange.

Ho₃: There is no significant relationship between retained earnings and financial performance of selected commercial banks listed on Uganda Securities Exchange.

Ho₄: There is no significant relationship between shareholders' capital and financial performance of selected commercial banks listed on Uganda Securities Exchange.

1.7 Scope of the study

1.7.1 Geographical scope

The study focused on 5 selected commercial banks listed on Uganda Securities Exchange. These were Bank of Baroda (Uganda) (BOBU), DFCU Group, KCB Group, Stanbic Bank Uganda Limited (SBU) and Equity Group Holdings Limited (EBL).

1.7.2 Content scope

The study focused on the effect of; short term debt financing on the financial performance, long term debt financing on the financial performance, retained earnings on the financial performance and shareholders' capital on the financial performance of selected commercial banks listed on Uganda Securities Exchange.

1.7.3 Time scope

The study was carried out between December 2016 to October 2017, whereby proposal writing took place between December, 2016 to June 2017, data collection and analysis was done between June and October, 2017, and then the final report was written and submitted in October, 2017. The study also considered panel data of selected commercial banks listed on Uganda Securities Exchange from 2010-2015.

1.7.4 Theoretical scope

This study is underpinned by capital structure theories of irrelevance (Modigliani and Miller, 1958), relevance (Modigliani and Miller, 1963), agency (Jensen and Meckling, 1976), trade off (Kraus and Litzenberger, 1973) and pecking order (Donaldson, 1961).

1.8 Significance of the study

Given that capital structure has a lot of influence on the financial performance of any commercial banks, this study was significant in the following ways.

Management

The findings of the study helped management of selected commercial banks in identifying capital structure mix and its impact on financial performance. This also helped managers not to conflict with the capital mix over their personal interests.

Employees

The study findings helped employees to avoid fraud and job negligence that result into incurring losses in the bank so as to improve financial performance.

Customers

The findings helped customers of selected commercial banks in being more responsible for capital mix by complying with the agreements of borrowing by

providing the authentic documents and making payments as agreed to help the bank reduce losses that result from loan defaulters.

Academicians and professionals

The study findings were also of practical significance to both academicians and general practitioners by providing a better insight into the understanding of the role of capital structure in promoting financial performance in selected commercial banks. The findings also added to the pool of knowledge on the shelves of University libraries and act as a ground for further research in the same areas.

1.9 Definition of operational key terms

Capital structure is how a firm finances its overall operations and growth by using different sources of funds. A firm's capital structure can be a mixture of long-term debt, short-term debt, common equity and preferred equity.

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

Profitability is the ability of a business to earn a profit. A profit is what is left of the revenue a business generates after it pays all expenses directly related to the generation of the revenue, such as producing a product, and other expenses related to the conduct of the business activities.

Long-term debt consists of loans and financial obligations lasting over one year. Long-term debt include any financing or leasing obligations that are to come due in a greater than 12-month period.

Short-term debt refers to any financial obligation that is either due within a 12-month period or due within the current fiscal year.

Retained Earnings are profits not paid out as dividends but retained for financial future investment needs.

Share capital is amount contributed by the owners and normally includes ordinary share capital, preference capital, retained earnings and reserves.

Residual is the difference between the actual value of Y (financial performance proxy; profitability) and the predicted value of Y.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Under this chapter the researcher analyzed and gave critical views on issues that were put forward by different scholars and academicians. Different subjects that included concept of capital structure, theoretical review, conceptual framework, financial performance, empirical literature review and research gaps were reviewed under different headings.

2.2 Theoretical review

A number of capital structure theories have been put forward to explain financial performance of commercial banks for example; irrelevance (Modigliani and Miller, 1958), relevance (Modigliani and Miller, 1963), agency (Jensen and Meckling, 1976), trade off (Kraus and Litzenberger, 1973) and pecking order (Donaldson, 1961) that provide the basis of study variables choice. In particular, capital structure irrelevance and relevance are reviewed since all of them are more relevant and support both independent and dependent variables as shown in the conceptual framework.

2.2.1 Modigliani and Miller capital structure irrelevance theory

This proposition was advanced by Modigliani and Miller (1958) who posited that without taxes and under assumptions of perfect markets, with no capital market frictions (i.e. no transaction costs, asset trade restrictions or bankruptcy costs), symmetric access to credit markets (banks and investors can borrow or lend at the same rate and bank financial policy reveals no information), each bank belongs to a risk class set with common earnings, a bank's debt-equity ratio does not affect its financial performance. Therefore, the value of the levered commercial bank is equal to the value of the unlevered commercial bank and hence capital structure financing decision is therefore irrelevant.

Modigliani and Miller (1958) argued that if two banks are identical in all respects but

only differ in their values of financial performance and in the way that they are financed, investors will sell shares of the overvalued bank, buy shares of the undervalued bank and continue this process until the two banks command the same value of financial performance through a process referred to as arbitrage. In essence, Modigliani and Miller (1958) theorized that a commercial bank with a particular set of expected cash flows simply divides them up among investors according to the proportion of debt and equity it uses to finance its assets (Luigi and Sorin, 2009). Dividing up those cash flows among investors has no effect on the company's financial performance (Brigham and Ehrhardt, 2010).

According to Modigliani and Miller (1958), the cost of equity of a levered commercial bank is equal to the cost of equity of an unlevered commercial bank plus a financial risk premium, which depends on the degree of financial leverage. It is therefore a linear function of the commercial bank's debt to equity ratio. Therefore, as debt increases, the cost of equity of the levered bank also increases. Using more debt in the capital structure will not increase the financial performance of the firm because the benefits of cheaper debt will be exactly offset by an increase in the riskiness of the equity and hence its cost to keep bank's financial performance remains constant.

According to Ross, Westerfield and Jaffe (1993), MM theorems are a cornerstone of finance for two reasons; the first is substantive and stems from their nature of irrelevance propositions. These propositions help us understand when these decisions may affect financial performance of the commercial banks and why. The second reason is methodological, that is, by relying on an arbitrage argument; they set a precedent not only within the realm of corporate finance but also within that of asset pricing. However, empirical works have shown that the MM irrelevance theorem fails under a variety of circumstances with the most commonly used elements including consideration of taxes, transaction costs, bankruptcy costs, agency conflicts, adverse selection, time-varying financial market opportunities, and investor clientele effects (Luigi and Sorin, 2009).

2.2.2 Modigliani and Miller capital structure relevance theory

This was proposed by Modigliani and Miller (1963) who incorporated taxes by modifying their irrelevance theory and argued that capital structure indeed matters in determining the commercial bank's financial performance. The theory was based on the fact that in many jurisdictions; interest on debt is an allowable expense hence shield commercial bank's taxes. Based on this assertion, commercial banks could borrow up to a 100% to reduce their taxes to zero if possible to effect a higher value of financial performance.

In practice however, commercial bank's tax system and personal tax system interact in complex ways. Miller (1977) suggested that the presence of taxes on personal income may reduce the tax advantage associated with debt financing which lead to a greater value of commercial bank's financial performance. This is because commercial banks could save corporate taxes by raising the debt to equity ratio, but investors would pay additional personal tax and, therefore, require higher returns to compensate for this fact and the higher associated risks. Modigliani and Miller proposition was therefore modified in 1977 to incorporate personal taxes but with the same argument that capital structure indeed matters for the financial performance of commercial banks. Graham and Harvey (2001) also posited that a typical commercial bank could double tax benefits by issuing debt until the marginal tax benefit begins to decline. It is not therefore possible for a commercial bank to have a 100% debt financing.

According to Breuer and Gürtler (2008), since different countries have different tax laws, the entire proposition on tax shield relevance could lose its validity if for instance a country changes its tax laws to deny advantage on interest on debt. A case in point is where a country's commercial banks are subject to thin capitalization status. A bank is said to be thinly capitalized if it is predominantly foreign controlled or where the debt outweighs equity by over three times (Blouin, Huizinga, Laeven and Nicodème, 2014). Multinational groups in particular are often able to structure their financing arrangements to establish a tax-efficient mixture of debt and equity designed to evade tax through loopholes in international transfer pricing rules

(Blouin *et al.*, 2014). To deter this illegality, any interest on excess debt does not enjoy tax shield implying that debt has obviously a maximum limit of tax advantage in a capital structure of commercial banks. The assertion of 100% debt financing is therefore not true for commercial banks.

In conclusion, Modigliani and Miller demonstrates that showing what does not matter can also show by implication, what does matter (Miller, 1988). By implication, if capital structure of commercial banks does in fact matter, then taxes and default risk could be good places to look for reasons why it matters (Miller, 1988). The fundamental Modigliani and Miller message is that any combination of finance sources of debt and equity of commercial bank is good for its financial performance.

2.2.3 Agency cost theory

The theory by Jensen and Meckling (1976) argue that an optimal capital structure of commercial banks is attainable by reducing the costs resulting from the conflicts between their managers, owners and debt holders in determination of their financial performance. In other words, the optimal capital structure of commercial banks results from a compromise between various funding options (own funds or loans) that allow the reconciliation of conflicts of interests between the capital suppliers (shareholders and creditors) and managers of commercial banks (Grigore and Stefan-Duicu, 2013).

Jensen and Meckling (1976) argued that debt can be used by commercial banks to control the managers' behaviour by reducing the free cash flows within the bank by ensuring prompt payment of interest payments to determine their financial performance. This minimizes the commercial banks' cash at the disposal of managers likely to be misappropriated through personal interests or still waste the cash in organizational inefficiencies at the expense of the commercial bank's objectives. Key among the objectives is maximization of commercial banks shareholders' wealth by maximizing profitability, a measure of financial performance.

2.2.4 Trade-off theory

This theory was postulated by Kraus and Litzenberger (1973). It is an extension of the Modigliani and Miller theory. It hypothesizes that the commercial bank's optimal capital structure results from the trade off from the influences of banks and personal taxes, agency and bankruptcy costs. Commercial banks must therefore, choose the level of debt that maximizes their financial performance from the tax shield. It is anchored on the idea that a commercial bank chooses how much debt finance and how much equity finance it should use by balancing the costs and the benefits. (Kraus and Litzenberger, 1973) after considering a balance between the dead weight costs of bankruptcy and the tax saving benefits of commercial bank's debt, developed a classical version of the hypothesis. This theory states that there is an advantage to financing commercial bank with debt and there is also a cost of financing with debt, the cost of financial distress and non-bankruptcy cost. The empirical relevance of trade off theory has often been challenged. Commercial banks will use debt as much as possible but watch out for any disadvantage that may arise as a result of a bankruptcy an issue that affects their financial performance. This is the point at which the tax saving from any additional unit of commercial bank's debt exactly equal to the cost which arises from an increase in the bank's financial distress probability (Ahmed Sheikh and Wang, 2011). The theory assumes the existence of different target leverage for different commercial banks due to their specific factors are already at their presumed targets for financial performance (Myers, 2001).

According to Luigi and Sorin (2009), trade-off theory grew out of the debate over the MM irrelevance theorem when corporate income tax was added, this created a benefit for debt in that it served to shield commercial bank's earnings from taxes implying a 100% debt financing which affects financial performance. In terms of profitability, trade-off theory asserts that more profitable commercial banks have more debt-serving capacity thus a higher debt ratio and vice versa (Luigi and Sorin, 2009). High profitable commercial banks with tangible assets that are relatively safe will use more debt than those banks with low profitability as well as those with risky intangible assets. In practice however, commercial banks do not operate with a 100% debt financing due to distress, bankruptcy and agency costs hence the need

to match the costs and benefits while determining their financial performance.

2.2.5 Pecking order theory

According to De Miguel and Pindado (2001) the theory was first suggested by Donaldson in 1961 and further developed by Myers and Majluf (1984). It argues that commercial banks have a preferred hierarchy for financing their decisions with the highest preference being to use internal financing before resorting to any form of external funds. This is because commercial bank's internal funds incur no flotation costs and require no additional disclosure of financial information that may lead to low financial performance (Mwangi, 2016). Castro, Tascón and Amor-Tapia (2012) also contend that this hierarchy is necessary in order to minimize commercial bank's adverse selection costs of security issuance as a result of the existence of asymmetric information and this will enable them to improve their financial performance.

In Myers and Majluf model (1984), investors rationally discount commercial bank's stock price when managers issue equity instead of riskless debt since to them, it shows the bank's stock is overvalued. To avoid this discounting, results to low financial performance and thus managers avoid equity whenever possible. The model therefore predicts that managers of commercial banks use internal funds first, then use debt and finally resort to equity when determining their commercial bank's financial performance. In the absence of investment opportunities, commercial banks retain profits and build up financial slack to avoid having to raise external finance in the future (Mwangi, 2016). According to Frank and Goyal (2007) confirmed that the greatest support for the pecking order is found among larger commercial banks since they are least risky and most likely to issue public bonds than small banks and therefore increases their financial performance.

The theory however assumes that commercial bank's managers know more about their current earnings and future growth opportunities than outside investors and they will act in the best interests of the bank's existing shareholders (Ahmed Sheikh and Wang, 2011). There is a strong desire to keep such information proprietary as

the use of internal funds precludes commercial bank's managers from having to make public disclosures about the bank's investment opportunities and potential profits to be realized from investing in them (Aoun, 2012).

2.3 Concept of capital structure

Capital structure refers to how a firm finances its assets with permanent short term debt, long term debt, preferred stock and common equity (Moyer *et al.*, 1999). In general, firms finance only a part of their assets with equity (ordinary, preference and retained earnings) capital, while the other part is financed by other resources such as long term financial debt or liabilities (like bonds, bank loans and other loans) and other short term liabilities for example trade payables (Moyer *et al.*, 1999). Titman *et al.*, (2011) defines capital structure as owners' equity and interestbearing debt including short term bank loans.

According to Abor (2005), capital structure is the mix of debt and equity that the firm uses in its operation and is a mixture of different securities. Firms can choose among many alternative capital structures. For example, firms can arrange lease financing, use warrants, issue convertible bonds, sign forward contracts or trade bond swaps. Firms can also issue dozens of distinct securities in countless combinations to maximize overall market value (Abor, 2005). Dare and Sola (2010) refer to capital structure as the debt-equity mix of business finance which is used to represent the proportionate effect of debt and equity in corporate firms' finances. Dare and Sola (2010) suggested that capital structure can take any of the following three alternatives: 100% equity:0% debt; 0% equity:100% debt or X% equity:Y% debt. Worth noting in their studies is the inclusion of short term debt as a capital structure component and therefore the justification of use of the terms financial and capital structures interchangeably.

Dare and Sola (2010), Chechet and Olayiwola (2014) had the following take on their proposed options. Option one; is that of a purely equity financed firm that ignores leverage and its benefits in financing its activities and all the distributions goes to equity providers. This however is rare in practice. Option two; is that of a firm that

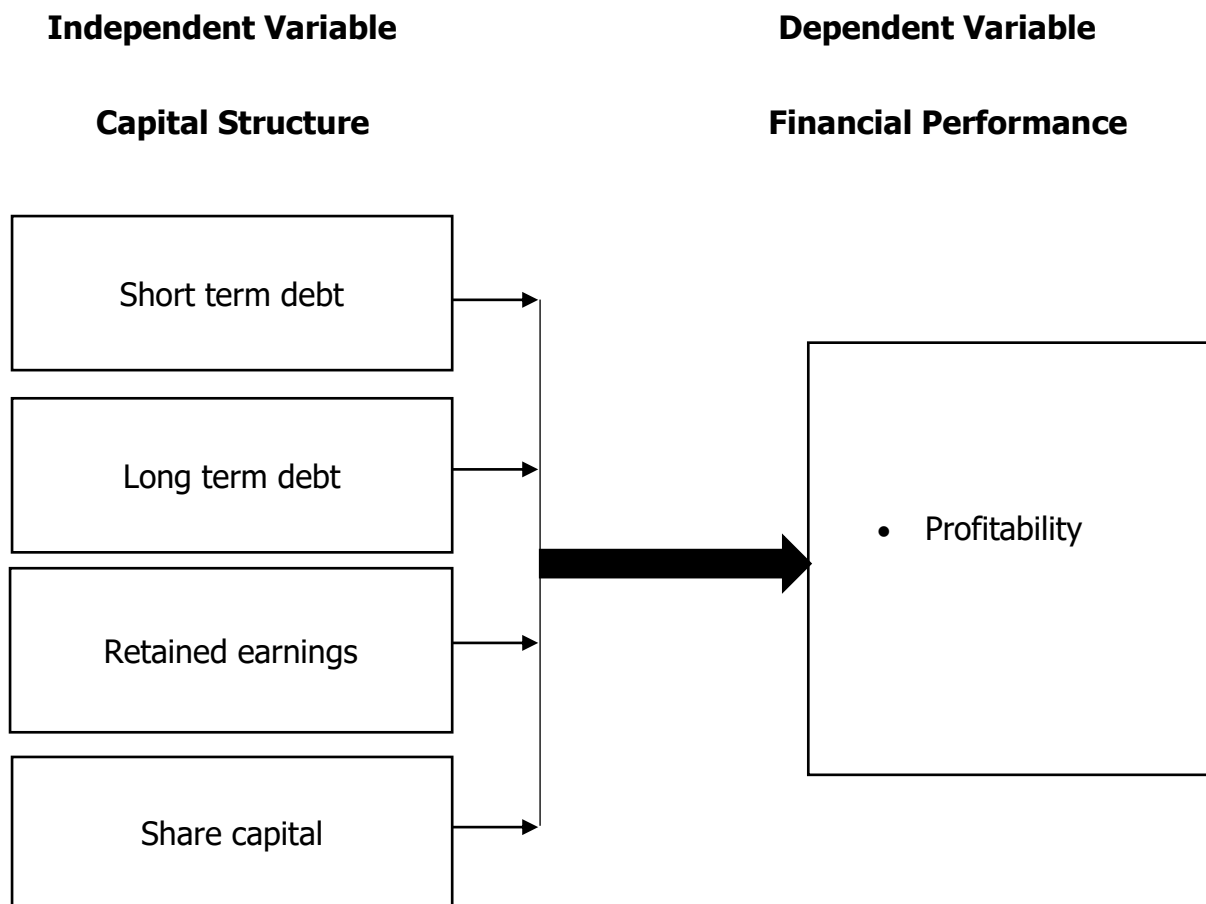
finances its affairs wholly on debt, again unrealistic in the real world situation too because hardly will any provider of fund invest in a business without owners. In essence, it is the equity element present in capital structure that motivates the debt providers to give their scarce resources to the business. Option three; is that of a firm combining certain proportion of both equity and debt in its capital structure. It will therefore reap the benefits of combined debt and equity while the cash flows generated are appropriated between equity and debt providers.

The challenge in option three as provided is the dilution of equity ownership and therefore the likelihood of emergence of agency conflict between the equity owners and debt providers (Chechet and Olayiwola, 2014). Capital structure decision is therefore very critical and fundamental in the business life cycle not only to maximize shareholders' wealth but also due to the impact it has both on sustainability and its ability to satisfy external objectives (Chechet and Olayiwola, 2014). Capital structure theory addresses the means of acquisition of finance available to a firm, the best mix of such sources that reduces the overall cost of capital while maximizing returns and the management to achieve the desired objectives (Abor, 2005).

2.4 Conceptual framework

A conceptual framework refers to a group of concepts that are broadly defined and systematically organized to provide a focus, a rationale, and a tool for the integration, presentation and interpretation of information (Cooper and Schindler, 2006). As noted by Smyth (2004), a well presented conceptual framework helps to explain the possible connections between the variables.

Figure 2.1: Conceptual framework of capital structure and financial performance



Source: Safeena and Hassan, 2014

2.4.1 Long term debts

Gitman *et al.*, (2015), argued that long-term debt consists of loans and financial obligations lasting over one year. Long-term debt for a company would include any financing or leasing obligations that are to come due in a greater than 12-month period. Financial and leasing obligations, also called long-term liabilities, or fixed liabilities, would include company bond issues or long-term leases that have been capitalized on a firm's balance sheet. According to Rosset *et al.*, (2008), the company's debts are categorized as either financial liabilities or operating liabilities on a balance sheet. Financial liabilities refer to debts owed to investors or stockholders; these include bonds and notes payable. Operating liabilities refer to the leases or unsettled payments incurred in order to maintain facilities and services for the company.

These include everything from rented building spaces and equipment to employee pension plans. Bonds are one of the most common types of long-term debt. Bond sales bring in immediate income, but the company ends up paying for the use of investors' capital due to interest payments.

Loughran and Vijh (1997) posited that it is of significance for a company to take on long-term debt in order to acquire immediate capital. For example, startup ventures require substantial funds to get off the ground and pay for basic expenses, such as research expenses, Insurance, License and Permit Fees, Equipment and Supplies and Advertising and Promotion. All businesses need to generate income, and long-term debt is an effective way to get immediate funds to finance and operations. However long term debt is harmful since debt sums tend to be large, these loans take many years to pay off. Companies with too much long-term debt will find it hard to pay off these debts and continue to thrive, as much of their capital is devoted to interest payments and it can be difficult to allocate money to other areas. A company can determine whether it has accrued too much long-term debt by examining its debt to equity ratio.

According to Altman and Hotchkiss (2010), a high debt to equity ratio means the company is funding most of its ventures with debt. If this ratio is too high, the company is at risk of bankruptcy if it becomes unable to finance its debt due to decreased income or cash flow problems. A high debt to equity ratio also tends to put a company at a disadvantage against its competitors who may have more cash. On the other hand, a low debt to equity ratio is a sign that the company is growing or thriving, as it is no longer relying on its debt and is making payments to lower it. It consequently has more leverage with other companies and a better position in the current financial environment. However, the company must also compare its ratio to those of its competitors, as this context helps determines economic leverage.

2.4.2 Short term debts

Short-term debt, also known as short-term liabilities, refers to any financial obligation that is either due within a 12-month period or due within the current fiscal

year. The value of the short-term debt account is very important when determining a company's performance. If the account is larger than the company's cash and cash equivalents, this suggests that the company may be in poor financial health and does not have enough cash to pay off its short-term debts. Different types of short term loans may be applied by the bank (Hill, 2013). The first, and often the most common, type of short-term debt is a company's short-term bank loans. These types of loans arise on a business' balance sheet when the company needs quick financing in order to fund working capital needs. The second, and common type of short-term debt is a company's accounts payable. This liabilities account is used to track all outstanding payments due to outside vendors and stakeholders. If a company purchases a piece of machinery for \$10,000 on short-term credit, to be paid within 30 days, the \$10,000 is categorized as an accounts payable.

Thirdly, depending on the way in which employees are paid by their employers, salaries and wages can be considered short-term debt. If, for example, an employee is paid on the 15th of the month for work performed in the previous period, it would create a short-term debt account for the owed wages, until they are paid on the 15th. Fourthly, lease payments can also sometimes be short-term debt. Most leases are considered long-term debt, but there are sometimes leases that are expected to be paid within one year. If a company, for example, signs a six-month lease on an office space, it would be considered short-term debt. Finally, taxes are sometimes categorized as short-term debt. If a company owes quarterly taxes that have yet to be paid, it could be considered a short-term liability and be categorized as short-term debt.

2.4.3 Retained earnings

According to Samuel (2016) retained earnings are profits not paid out as dividends but retained for financial future investment needs. According to Khan (2009) retained earnings refer to 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 debt. In most cases, companies retain earnings in order to invest them into areas where the company can create growth opportunities, such as buying new machinery or

spending the money on more research and development (Markarian et al., 2008). Retained earnings are reported at the end of an accounting period as the accumulated amount of a company's prior earnings, net of dividends (Kieso et al., 2010). Kieso et al., (2010) argue that retained earnings can show a positive earnings accumulation or can turn negative and have a deficit if a current period's net loss exceeds the period's beginning retained earnings. Even though changes in retained earnings during each accounting period are not explicitly reported, they can be inferred by comparing the amounts of beginning and ending retained earnings of the period (Kieso et al., 2010). An increase or decrease in accumulated retained earnings during an accounting period is the direct result of the amounts of net income or loss and dividend payouts for that period.

2.4.4 Share capital

Share capital is the money invested in a company by the shareholders (Titman *et al.*, 2011). Share capital is a long-term source of finance. In return for their investment, shareholders gain a share of the ownership of the company. It is therefore that amount contributed by the owners and normally includes ordinary share capital, preference capital, retained earnings and reserves (Titman *et al.*, 2011). Share capital which is free of debt and represents ownership interest in a firm (Moyer *et al.*, 1999).

According to Ross et al., (2008) share capital consists of all funds raised by a company in exchange for shares of either common or preferred shares of stock. The amount of share capital or equity financing a company has can change over time. Bierman (1999) stressed that a company that wishes to raise more equity can obtain authorization to issue and sell additional shares, thereby increasing its share capital. According to Kieso et al., (2010) argues The amount of share capital a company reports on its balance sheet only accounts for the total amount initial paid by shareholders. If those shareholders later resell their shares on the secondary market, any difference between the initial and subsequent sales prices does not impact the company's share capital.

2.5 Financial performance

Financial performance is the process of measuring the results of a firm's policies and operations in monetary terms (Erasmus, 2008). Metcalf and Titard (1976) defined financial performance as the act of performing financial activity in order to achieve financial objectives over a specific period of time. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

Metcalf and Titard (1976) stated that the financial performance is to convey an understanding of some financial aspects of a business firm. It may show the position of a firm at a moment in time as presented in statement of financial position or may reveal a series of activities over a given period of time as is presented in statement of comprehensive income.

The financial performance identifies the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the statement of financial position and statement of comprehensive income by selecting the information relevant to the decision under consideration from the total information contained in the financial statements, arranging the information in a way to highlight significant relationships to be interpreted and draw conclusions. For this case, ratios are used as a benchmark for evaluating financial performance of a firm and help to summarize large quantities of financial data to make qualitative judgments about the firm's financial performance. Tharmila and Arulvel (2013), measures financial performance of a firm as return on equity and return on assets. According to Erasmus (2008), profitability, return on equity and liquidity ratios among others provide valuable tools or measures to stakeholders to evaluate the past and current financial performance of a firm.

2.5.1 Profitability

According to Mungal (2015) profitability is defined as an income generated in the business which is calculated by subtracting the expenses from the revenue. Karuru (2005) posited that profitability is the difference between the sales generated by a

business and the expenses incurred during the business operations. The author also emphasised that it is important to maximise the sales amount of a business by significantly reducing the expenses incurred in the business. Furthermore, Karuru (2005) contend that profitability is the difference between the revenue and the operational expenses incurred in the business. The author also added that all businesses should aim at significantly reducing their operational expenses and aim at increasing their incomes to maintain a positive net income. This positive net income is referred to as a profit. The above definitions indicate that profitability is a positive balance after calculating the difference between the businesses sales and the operational expenses i.e., $\text{Profit} = \text{Sales} - \text{Expenses}$.

2.6 Empirical literature review

According to Zikmund, Babin, Carr and Griffin (2015), empirical literature review is a directed search of published works, including periodicals and books that discuss theories and present empirical findings by other scholars that are relevant to the research topic under study. It therefore provides a platform for analysing the variables, their relationships and to critique the findings where necessary. This section therefore provides a review of such empiricals.

2.6.1 Relationship between short term debt financing and financial performance

Short term debt financing has a maturity period of one year or less, they must be repaid quickly within 90-120 days. Maturity matching between debt and the life of assets plays an important role in deciding the length of the debt maturity (Heyman *et al.*, 2007). According to Benmelech and Dvir (2013), term loans with short maturities help to meet immediate need for financing without long term commitment. Benmelech and Dvir (2013) further stressed that the cost of servicing short term debt is less taxing on the company. Short term loans usually offer lower interest charges, and most lenders do not charge interest until all credit allowance period is breached. The study by El-Sayed Ebaid (2009) sought to establish the relationship between debt level and financial performance of companies listed on the

Egyptian stock exchange. The study found out that there was a negative impact of short term debt on return on assets.

Teruel and Solane (2008) analyzed the Spanish SMEs and found that firms with a higher amount of short-term debt will hold higher levels of cash, because it might lower the risks of the non-renewal the short-term debt. Palombini and Nakamura (2012) in their study on debt financing suggest that aggressive liquidity policy combine the higher levels of normally lower cost short-term debt and less long-term capital. Although capital costs are reduced, this increases the risk of a short-term liquidity. They established that total and short-term debt is positively related to firm's profitability, which might be the most important factor in accessing outside financing in countries with weak collateral laws. From their studies they also found out that a negative relation between tangibility and short-term debt and a positive relationship between tangibility and long-term debt exists.

According to Teruel and Solane (2008), short-term debt is positively correlated with firm's growth opportunities. The anecdotal evidence suggests that there is a positive relationship between short term debt financing and financial performance. Furthermore, it has been argued that short-term debt influences a firm's financial performance negatively, because short-term debt exposes firms to the risk of refinancing (Zeitun and Tian, 2014).

2.6.2 Relationship between long term debt financing and financial performance

Long term debt is money that is owed to lenders for a period of more than one year from the date of current balance sheet. The study by El-Sayed Ebaid (2009) found that there was no significant relationship between long term debt and return on assets. Long term debts are most preferable sources of debt financing among well-established corporate institution mostly by virtue of their asset base and collateral is a requirement many deposit taking financial institutions. According to Berger and Udell (2006), large financial banks have considerably reduced lending to SMEs thus inhibiting their potential for growth and financial performance.

Kyereboah and Coleman (2007), found that long term debt positively and significantly impacts ROE but not significantly impact on ROA of MFIs. This shows that if MFIs use long term debt to finance their operations, there may not be a pressure on management of MFI. This further suggests that profitable MFIs depend more on long term debt financing.

Pelham (2000) posited that long term debts provided small and medium-sized manufacturing firms with more competitive advantages when compared with large firms. According to Pelham (2000) found out that there is a direct positive and significant relationship between long term loans and financial performance of the small businesses. He reported that long term debt was positively related to the gross profit in small and medium size manufacturing firms.

Gatsi *et al.*, (2010) cited Abor (2005) and Amidu (2007) that firms use a relatively lesser amount of long-term debt to finance their activities relative to short-term debt. According to Abor (2005), there exist an inverse relationship between company profitability and long-term debt. Amidu (2007) observed a positive association between long-term debt and firm profitability.

2.6.3 Relationship between retained earnings and financial performance

Retained earnings are profits not paid out as dividends but retained for financial future investment needs. The cost of retained earnings (internal equity) is the foregone benefits/dividends by ordinary shareholders. If the cost of retained earnings is low compared to the cost of new ordinary share capital, the firm will retain more and pay fewer dividends (Samuel, 2016 cited in Ilhomovich, 2009). Additionally, the use of retained earnings as an internal source of finance is preferred because it does not involve any floatation costs and does not dilute ownership and control of the firm, since no new shares are issued. According to Phillips and Sipahioglu (2004), retained earnings are an internal source of finance thus, when they are high there is low gearing, lower financial risk and thus highest market price share. It assumes that retained earnings is the best source of long term

capital since it is readily available and cheap. This is because no floatation cash are involved in use of retained earnings to finance new investments.

Keister (2004) found out that retained earnings increased the likelihood of borrowing from all sources in the first decade of reforms. This finding is consistent with arguments that earnings signalled financial wellbeing to potential creditors and increased firm's ability to attract external funds. A study by Khan (2012) found that retention ratio and return on equity has significant positive relation with financial performance and significantly explains the variations in the stock prices of chemical and pharmaceutical sector of Pakistan. According to Khan (2012), the prime idea behind earnings retention is that the more the company retains the faster it has chances for growth.

Furthermore, Khan, Zulfiqar and Shah (2012) studied the effect of retained earnings on future profitability and stock returns and established a weak positive relationship between a firm's retained earnings and stock performance in Pakistan. According to Mirza and Azfa (2010) retained earnings ultimately come back to the equity shares in the form of enhanced dividend or capital gains.

2.6.4 Relationship between share capital financing and financial performance

According to Kongmanila and Kimbara (2007), share capital financing is money acquired from the business owners themselves or from other investors through contributions. According to Maina and Ishmail (2014), stated that equity capital is the mode that enables equity holders to exert influence and monitor managerial decisions continuously through the board of directors. Furthermore, Kisgen (2006) contend that capital shareholders stay closer to the firm in order to diminish agency costs caused by the risk that managers are likely to give in too much to labour demands hence leading to financial performance. It is also likely to result in greater value to equity holders and thereby increasing firm financial performance. Booth *et al.*, (2001) argues that the firm that uses share capital to finance their operations are able to make their financial performance better since there is direct

control and because all the shareholders are the residual claimants they have to ensure that resources are allocated efficiently to be able to maximize their wealth. Booth *et al.*, (2002) arguments have been supported by Nunkoo and Boateng (2010) who found that use of equity capital is positively related to the financial performance of firms.

Shubita and Alsawalhah (2012) suggest that firms with high profits depend heavily on equity capital as their main financing option. They also suggested that equity capital financing has a positive relationship to financial performance. Mungai (2014) contend that private equity capital backed companies perform more strongly (higher return on assets, higher interest cover, higher gross margin) than a matched sample of private and listed companies.

McLaughlin *et al.*, (1996) found that firms with more investment and growth opportunities opt for equity issuance to avoid debt which is tied to periodic interest payments. Equity financing add value to shareholders by way of improving capital structure of firms to an optimal level so as to balance the benefits of the tax shield and the costs of financial distress (Myers, 2001).

2.7 Research gaps

It is apparent from the existing literature that many surveys are either deficient of adequate variables or the scope of study is wanting. According to surveys of Shivdasani and Zenner (2005),Kaumbuthu (2011), Shubita and Alsawalhal (2012), Chisti *et al.*, (2013), Zurigat (2009), Maina and Ishmail (2014) and Chechet and Olayiwola (2014) did not split debt into short and long term in their analysis. It would have been imperative to split debt since there is a possibility that the two contributes differently to their response variable proxies. It is also evident in all surveys that equity capital has not been separated so as to analyse in isolation the impact of retained earnings, ordinary and preference capital on financial performance (Maina and Ishmail 2014; Chechet and Olayiwola, 2014). It is also evident in all surveys that equity capital has not been separated so as to analyse in

isolation the impact of retained earnings, ordinary and preference capital on financial performance.

Studies undertaken by Gleason et al., (2000); Gul et al., (2011); Velnampy and Niresh (2012); Dietrich and Wanzenried (2009); Mesquita and Lara (2003); Taani (2013); Awunyo-Vitor and Badu (2012), Abor (2005) and Silva (2008), found conflicting results on effect of capital structure of firms. In the review of Empirical literature, few local studies have been conducted in East Africa such as; Orua (2009), Kamau (2009), Kibet (2009), Ondiek (2010), Wachilonga (2013), Salamba (2015) and concentrated on the effect of capital structure on microfinance institutions, industrial firms and SMEs in East Africa.

In Uganda, few studies were conducted on capital structure. These were in microfinance institutions (Sekabira, 2013), electricity generation projects (Mutyaba, 2014) but none was conducted in commercial banks. In view of the foregoing, this study therefore tried to address some of these deficiencies.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This chapter described the procedures that were followed in conducting the study. These included research design, research data, sample size, sampling procedure, data sources, research instruments, measurement of variables, data analysis and ethical considerations.

3.2 Research design

The study employed longitudinal research design using panel data analysis so as to collect quantitative data about the variables under study by using quantitative tool. The researcher selected a sample of panel data at the outset of the study and then at each subsequent panel data collection point, the researcher surveyed the same sample (Bryman & Bell, 2015). This was done over time, and helped the researcher to note the changes in specific data and explored reasons for data change. The panel data also has the advantage of giving more informative data as it consists of both the cross-sectional information, which captures individual variability, and the time-series information, that captures dynamic natures of the data (Bryman & Bell, 2015).

3.3 Research data

The study employed panel data of 5 commercial banks listed on Uganda Securities Exchange over the period of 2010-2015 (USE, 2015). The study included panel data analysis from only commercial banks listed on USE that were in existence in Uganda for the last six years that is between 2010 and 2015 (Uganda Securities Exchange, 2015) which included Bank of Baroda (Uganda) (BOBU), DFCU Group, KCB Group, Stanbic Bank Uganda Limited (SBU) and Equity Group Holdings Limited (EBL). The six-year period that is from 2010-2015 was chosen because it is current and thus helped in obtaining valid conclusions for the study.

3.4 Sample size

The study sample size targeted panel data of 5 commercial banks listed on Uganda Securities Exchange. The sample size considered all 5 listed commercial banks since it is acceptable in causal comparative research to consider all participants if the sample size is less than 30 participants (Amin, 2005).

3.5 Data sources

The researcher used only secondary data for data collection. Secondary data was gathered from secondary sources of the selected commercial bank's extracted financial statements and annual financial reports that were issued by the banks at end of each year.

3.6 Research instruments

The researcher collected data using observations. This is a systematic viewing coupled with consideration of the seen phenomenon as they occur in nature with regard to cause and effect mutual relationship. The researcher used this instrument to observe the changes in the panel data of commercial banks over the period of six years (i.e. 2010-2016).

3.7 Measurement of variables

The study variables were measured as shown below;

Table 3.1 Measurement of variables

Type of Variable	Variable	Measurement	Author(s)
Independent	Short Term Debt (STD)	Ratio of short term debt to total assets	Abor (2005)
Independent	Long Term Debt (LTD)	Ratio of long term debt to total asset	Ozkan (2001)
Independent	Retained	Ratio of retained earnings	Titman &

	Earnings (RE)	to total assets	Wessels(2016)
Independent	Share Capital (SC)	Ratio of reserves, preference and ordinary capital to total assets	Demirguc-Kunt, Detragiache & Merrouche (2013)
Dependent	Financial Performance	Profitability(PROF) will be computed as net profit / net interest income,	Demirgüç-Kunt & Huizinga (2015); Kosmidou, Tanna & Pasiouras (2015); El-Sayed Ebaid (2009) and Hassan & Bashir (2013).

Source: Safeena and Hassan (2014)

3.8 Data analysis

Data collected from annual reports of commercial banks was analyzed using a Statistical Package for Social Sciences (SPSS), which helped to show data in percentages. The mean was applied for the extent of capital structure and financial performance of selected commercial banks. Panel data regression was used to determine the significant effect between the variables.

The relationship between capital structure and financial performance of commercial banks was tested by the following regression models:

$$\text{Financial performance (PROF}_{i,t}) = \beta_0 + \beta_1 \text{STD}_{i,t} + \beta_2 \text{LTD}_{i,t} + \beta_3 \text{RE}_{i,t} + \beta_4 \text{SC}_{i,t} + \varepsilon_{i,t}$$

Where;

$\text{STD}_{i,t}$ = Short Term Debt to Total Assets for bank i in year t

$\text{LTD}_{i,t}$ = Long Term Debt to Total Assets for bank i in year t

$\text{RE}_{i,t}$ = Retained Earnings to Total Assets for bank i in year t

$SC_{i,t}$ = Reserves, Preference and Ordinary Capital to Total Assets for bank i in year t

β_0 = the constant whose influence on the model is insignificant

β_1 = the slope which represents the degree with which the financial performance change as the capital structure variable change by one unit

$\varepsilon_{i,t}$ = the error term

3.9 Assumptions for multiple regression

The study tested the following assumptions for multiple linear regression;

3.9.1 Linear relationship

According to Steve, Stuart & David (2014), the relationship model should be linear. The dependant variable (outcome variable) should have a rough linear relationship with each of the independent variables, taking into account the other independent variables in the model (Steve, Stuart & David, 2014). Therefore, profitability, a proxy of financial performance should be linearly related to all independent variables (capital structure constructs) under the study. This assumption was examined to a fairly satisfactory extent simply by plotting scatterplots of the relationship between each capital structure constructs and financial performance, profitability. The scatterplot was checked to ensure that each scatterplot exhibit a linear relationship between variables.

3.9.2 Homoscedasticity

This means that the variance of the residuals should be constant at each level of the explanatory variables. Steve, Stuart & David (2014) contend that this can be tested for each separate explanatory variable, though it is more common just to check that the variance of the residuals is constant at all levels of the predicted outcome from the full model (i.e. the model including all the explanatory variables). In other words, for each value of the independent variables (capital structure constructs), the residuals should be constant. This assumption was examined by checking that

residuals vary in a clear pattern and systematically with the predicted values by plotting the residuals against the values predicted by the regression model.

3.9.3 Independent errors

Cohen, Manion and Morrison (2013) stressed that independent errors means that residuals should be uncorrelated that is for any pair of observations, the error terms (residuals) should be uncorrelated implying that residuals should be independent. This was tested using Durbin Watson statistic which is a number that tests for autocorrelation in the residuals from a statistical regression analysis. The Durbin-Watson statistic is always between 0 and 4. A value of 2 means that there is no autocorrelation in the sample and thus the residuals are independent. Values approaching 0 indicate positive autocorrelation and values toward 4 indicate negative autocorrelation (Steve, Stuart & David, 2014).

3.9.4 Variable type

According to Steve, Stuart & David (2014), dependent variable (financial performance) must be continuous. Also independent variables (capital structure) may be continuous, ordinal or nominal but each must have at least a small range of values even if there are only two categorical possibilities. The study therefore, have continuous independent and dependent variables.

3.9.5 Multicollinearity

Multicollinearity exists when two or more of the independent variables are highly correlated (Vaughn, 2008). Steve, Stuart & David (2014) also suggested that the two variables may actually represent the same underlying factor. The simplest way to ascertain whether or not independent variables are highly correlated with each other is to use correlation matrix or collinearity statistics that SPSS can provide which include Variance Inflation Factor (VIF) and tolerance statistic which tell whether or not a given independent variable has a strong relationship with the other independent variables (Steve, Stuart & David, 2014). Not uncommonly a VIF of 10 or even one as low as 4 (equivalent to a tolerance level of 0.10 or 0.25) have been

used as rules of thumb to indicate excessive or serious multi-collinearity (Menard, 1995).

Zhang and Wang (2013) (as in Menard, 1995) states "a tolerance of less than 0.20 is cause for concern; a tolerance of less than 0.10 almost certainly indicates a serious collinearity problem." VIF is the inverse of tolerance, and a tolerance of 0.20 corresponds to the rule of 5 and a tolerance of 0.10 to the rule of 10. However, according to Neter et al., (1989), a maximum VIF value in excess of 10 is often taken as an indication that multi-collinearity may be unduly influencing the least square estimates and that independent variable must be removed from analysis." The study considered independent variables to be highly correlated at a tolerance level of greater than 0.2 to ascertain whether or not independent variables are highly correlated with each other (Steve, Stuart & David, 2014).

3.9.6 Normally distributed residuals

Steve, Stuart & David (2014) contend that the residuals should be normally distributed. A histogram of the residuals (errors) can be used to check that they are normally distributed. However it is often hard to tell if the distribution is normal from just a histogram so additionally a P-P plot should be used. The study used the P-P plot to examine if residuals are normally distributed.

3.10 Ethical considerations

The selected commercial bank's panel data collected was only used for research purposes. The researcher obtained selected commercial bank's annual reports from their individual websites and used the figures as indicated in annual reports without making commission errors. The researcher also acknowledged the authors quoted in this study through citations and referencing, and presented the findings in a generalized manner.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTERPRETATION OF DATA

4.1 Introduction

Under this chapter the researcher presented, interpreted and analyzed the findings according to the research objectives of the study to help in making a thorough analysis. Tables were used to present and analyze the findings. The study investigated panel data of selected commercial banks listed on USE because they are considered highly regulated and their financial performance is heavily influenced by regulation. The data was collected from USE, commercial bank's extracted financial statements and annual reports published on their websites issued at end of each year for a six-year period of 2010-2015.

The chapter was segmented into three major sections of descriptive statistics, regression analysis and hypotheses testing. Section 4.2 described the descriptive statistics of the variables of the study. Whereas section 4.3, 4.4, 4.5 and 4.6 illustrated the regression analysis which was done in order to present the research objectives of the study. Further, Section 4.7 discussed multiple regression results while section 4.8 discussed relationship between the variables. Section 4.9 described the hypotheses testing by comparing the P-Value obtained using SPSS with 0.05 which is the alpha level of significance.

The study used profitability as a proxy for financial performance. This helped the researcher to come up with valid conclusions.

4.2 Descriptive statistics on research variables

This section discusses the descriptive statistics on research variables from selected commercial banks' panel data analysed for six-year duration. The descriptive statistics for dependent variable that is financial performance (Profitability) and the independent variable that is capital structure (short term debt, long term debt,

retained earnings and share capital) show the results indicated in the table 4.1 below;

Table 4.1: Descriptive Statistics on research variables

	N	STD	LTD	RE	SC	Prof
2010	6	78.3059	3.6	3.1922	23.2982	0.014
2011	6	79.6183	5.0	3.2095	24.9546	0.018
2012	6	81.6552	5.1	3.6761	24.9749	0.020
2013	6	82.7108	5.9	3.8524	28.3603	0.022
2014	6	83.6024	6.3	4.1273	29.2083	0.026
2015	6	89.1662	3.6	4.4523	36.1116	0.014
Valid N	6					

Source: SPSS Output, 2017

Table 4.1 presents a summary of descriptive statistics of the dependent and independent variables used in the study. First, the mean of profitability (Prof) are approximately 0.014, 0.018, 0.020, 0.022, 0.026 and 0.014 in year of 2010, 2011, 2012, 2013, 2014 and 2015 respectively. Descriptive statistics show the mean of short term debt (STD) as 78.3059 in 2010, 79.6183 in 2011, 81.6552 in 2012, 82.7108 in 2013, 83.6024 in 2014 and 89.1662 in 2015. This implies that selected commercial banks listed on USE finance their overall operations and growth using short term debt.

The descriptive statistics of long term debt (LTD) in 2010 is indicated by 3.6, 5.0 in 2011, 5.1 in 2012, 5.9 in 2013, 6.3 in 2014 and 3.6 in 2015. This indicates that selected commercial banks listed on USE finance their overall operations and growth by an average using the long term debt. Whereas the descriptive statistics indicate mean of retained earnings (RE) is indicated by 3.1922 in 2010, 3.2095 in 2011, 3.6761 in 2013, 3.8524 in 2014, 4.1273 in 2015 and 4.4523 in 2015. This indicates that selected commercial banks listed on USE finance their overall operations and growth by an average using retained earnings.

The descriptive statistics of shareholder's capital (SC) is indicated as 23.2982 in 2010, 24.9546 in 2011, 24.9749 in 2012, 28.3603 in 2013, 29.2083 in 2014 and 36.1116 in 2016. This indicates that selected commercial banks listed on USE finance their overall operations and growth by an average using shareholder's capital. However, financial managers for individual selected commercial banks listed on USE should employ more long term debt and retained earnings to increase their respective financial performance.

4.3 Effect of short term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The regression results shown in table 4.2A, 4.2B and 4.2C, below indicate the effect of short term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange.

Table 4.2 A: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.196 ^a	.038	-.202	.005142

a. Predictors: (Constant), STD

From table 4.2A, results indicate that $R^2 = 0.038$, therefore, the predictor variable that is short term debt (STD) account for 4% of the variance in financial performance of selected commercial banks. The remaining 96% of other variables such as bank size and growth accounted for financial performance of listed commercial banks. This implies that short term debt contributes towards financial performance of selected commercial banks by 4%.

Table 4.2 B: Analysis Of Variance (ANOVA^a)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	.160	.710 ^b
	Residual	.000	4	.000		
	Total	.000	5			

a. Dependent Variable: Profitability

b. Predictors: (Constant), STD

From table 4.2B, results indicated that the overall computed probability value (p-value) of predictor variable that is short term debt (STD) is 0.710. This value is greater than the level of statistical significance (sig.), alpha ($\alpha = 0.05$). This implies that the regression analysis is statistically insignificant and thus short term debt insignificantly affects financial performance of commercial banks listed on USE.

Table 4.2 C: Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.001	.050		.021	.984
	STD	.000	.001	.196	.400	.710

a. Dependent Variable: Profitability

The results in table 4.2C, indicated that short term debt is positively ($\beta = 0.000$) and insignificantly (p-value = 0.710) related to financial performance. The individual tests of computed probability value of short term debt is 0.710 and this is much greater than the level of statistical significance value ($\alpha = 0.05$). This implies that the amount of unique variance the short term debt account for in predicting selected commercial bank's financial performance is statistically insignificant. This indicates that an increase in short term debt increases the financial performance of commercial banks listed on USE and a decrease in short term debt decreases financial performance of selected commercial banks.

4.4 Effect of long term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The effect of long term debt financing on the financial performance of selected commercial banks listed on USE is indicated by the regression results shown in table 4.3A, 4.3B and 4.3C.

Table 4.3 A: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.330 ^a	.109	-.114	.004951

a. Predictors: (Constant), LTD

From the table 4.3A, $R^2 = 0.109$, therefore, long term debt account for 11% of the variance in financial performance of selected commercial banks. The remaining 89% were for other variables such as bank size and growth which accounted for financial performance of listed commercial banks. This implies that long term debt contributes towards financial performance of selected commercial banks by 11%.

Table 4.3 B: Analysis Of Variance (ANOVA^a)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	.488	.523 ^b
	Residual	.000	4	.000		
	Total	.000	5			

a. Dependent Variable: Profitability

b. Predictors: (Constant), LTD

Results from table 4.3B, indicate that the overall computed probability value (p-value) of predictor variable that is long term debt (LTD) is 0.523. This value is greater than the level of statistical significance (sig.), alpha ($\alpha = 0.05$). This implies that the regression analysis is statistically insignificant. Thus, long term debt insignificantly contributes towards financial performance of commercial banks listed on USE.

Table 4.3 C: Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.013	.012		1.113	.328
LTD	.001	.002	.330	.698	.523

a. Dependent Variable: Profitability

The results in the table 4.3C, indicated that long term debt is positively ($\beta = 0.001$) and insignificantly (p-value = 0.523) related to financial performance. From table, the individual tests of computed probability value of long term debt of 0.523 is greater than the level of statistical significance value ($\alpha = 0.05$). This implies that the amount of unique variance the long term debt account for in predicting selected commercial bank's financial performance, is statistically insignificant. This indicates that an increase in long term debt increases the financial performance of selected commercial banks listed onUSE and a decrease in long term debt decreases their financial performance.

4.5 Effect of retained earnings on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The regression results shown in table 4.4A, 4.4B and 4.4C, below indicate the effect of retained earnings on the financial performance of commercial banks listed onUSE.

Table 4.4 A: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.360 ^a	.130	-.088	.004891

a. Predictors: (Constant), RE

According to table 4.4A, $R^2 = 0.130$, therefore, the predictor variable of retained earnings account for 13% of the variance in financial performance of selected commercial banks listed on USE. The remaining 87% were for other variables such

as bank size and growth which accounted for financial performance of listed commercial banks. This implies that retained earnings contribute towards financial performance of selected commercial banks by 13%.

Table 4.4 B: Analysis Of Variance (ANOVA^a)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	.597	.483 ^b
	Residual	.000	4	.000		
	Total	.000	5			

a. Dependent Variable: Profitability

b. Predictors: (Constant), RE

From the table 4.4C, the overall computed probability value (p-value) of predictor variable that is retained earnings (RE) is 0.483. This value is much greater than the level of statistical significance (sig.), alpha ($\alpha = 0.05$). This implies that the regression analysis is statistically insignificant and therefore, retained earnings insignificantly contribute towards financial performance of selected commercial banks.

Table 4.4 C: Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.034	.017		2.040	.111
	RE	-.003	.004	-.360	-.773	.483

a. Dependent Variable: Profitability

The results in table 4.4C, indicated that retained earnings are negatively ($\beta = -0.003$) and insignificantly (p-value = 0.483) related to financial performance. The individual tests of computed probability value of retained earnings of 0.483 is greater than the level of statistical significance value ($\alpha = 0.05$). This implies that the amount of

unique variance the retained earnings account for in predicting selected commercial bank's financial performance is statistically insignificant. This indicates that an increase in retained earnings decreases the financial performance of selected commercial banks listed on USE whereas a decrease in retained earnings increases the financial performance of selected commercial banks.

4.6 Effect of shareholders' capital on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The effect of shareholders' capital on the financial performance of commercial banks listed on USE is indicated by the regression results shown in table 4.5A, 4.5B and 4.5C.

Table 4.5 A: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.692 ^a	.479	.349	.003785

a. Predictors: (Constant), SC

From table 4.5A, results indicate that R-squared, $R^2 = 0.479$, therefore, shareholder's capital account for variance in financial performance of selected commercial banks by 48%. Other variables such as bank size and growth account for financial performance of commercial banks by 52%. This implies that shareholder's capital contributes towards financial performance of commercial banks by 48%.

Table 4.5 B: Analysis Of Variance (ANOVA^a)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	3.680	.128 ^b
	Residual	.000	4	.000		
	Total	.000	5			

a. Dependent Variable: Profitability

b. Predictors: (Constant), SC

Results from table 4.5B, indicate that the overall computed probability value (p-value) of predictor variable that is SC (shareholder's capital) is 0.128. This value is higher than the level of statistical significance (sig.), alpha ($\alpha = 0.05$). This implies that the regression analysis is not statistically significant. Furthermore, shareholder's capital insignificantly contributes towards financial performance of selected commercial banks listed on USE.

Table 4.5 C: Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.040	.010		3.943	.017
	SC	-.001	.000	-.692	-1.918	.128

a. Dependent Variable: Profitability

The results in table 4.5C, indicated that shareholder's capital is negatively ($\beta = -0.001$) and insignificantly (p-value = 0.128) related to financial performance of selected commercial banks listed on USE. The individual tests of computed probability value of shareholder's capital of 0.128 is higher than the level of statistical significance value ($\alpha = 0.05$). This implies that the amount of unique variance the shareholder's capital account for in predicting selected commercial bank's financial performance, is not statistically significant. This indicates that shareholder's capital does not affect financial performance of selected commercial

banks listed on Uganda Securities Exchange. Therefore, an increase in shareholder's capital decreases financial performance of selected commercial banks listed on USE and a decrease in shareholder's capital increases financial performance of selected commercial banks listed on USE.

4.7 Testing multiple regression assumptions

The findings presented in the following tables tested the assumptions of multiple regression.

4.7.1 Independent errors

This assumption is examined to test if the residuals are uncorrelated implying that residuals should be independent. This is examined using table 4.6A.

Table 4.6 A: Independent errors

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.801 ^a	.642	-.791	.006277	2.314

a. Predictors: (Constant), SC, LTD, STD, RE

b. Dependent Variable: Profitability

From the table 4.6A above the value of Durbin Watson statistic is 2.314. A rule of thumb is that Durbin-Watson test statistic value of 2 means that there is no autocorrelation in the sample and thus the residuals are independent. Whereas values approaching 0 indicate positive autocorrelation and values toward 4 indicate negative autocorrelation. Therefore, according to this statistic, it implies that there is negative autocorrelation between the residuals and thus they are not independent.

4.7.2 Multicollinearity

This assumption was examined to test if two or more of the independent variables are highly correlated. This is explained by table 4.6B.

Table 4.6 B: Multicollinearity

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-.010	.100		-.098	.938		
STD	.000	.001	.334	.418	.748	.560	1.785
LTD	.001	.003	.247	.404	.756	.960	1.042
RE	.005	.011	.535	.466	.722	.272	3.673
SC	-.001	.001	-.993	-1.037	.488	.390	2.562

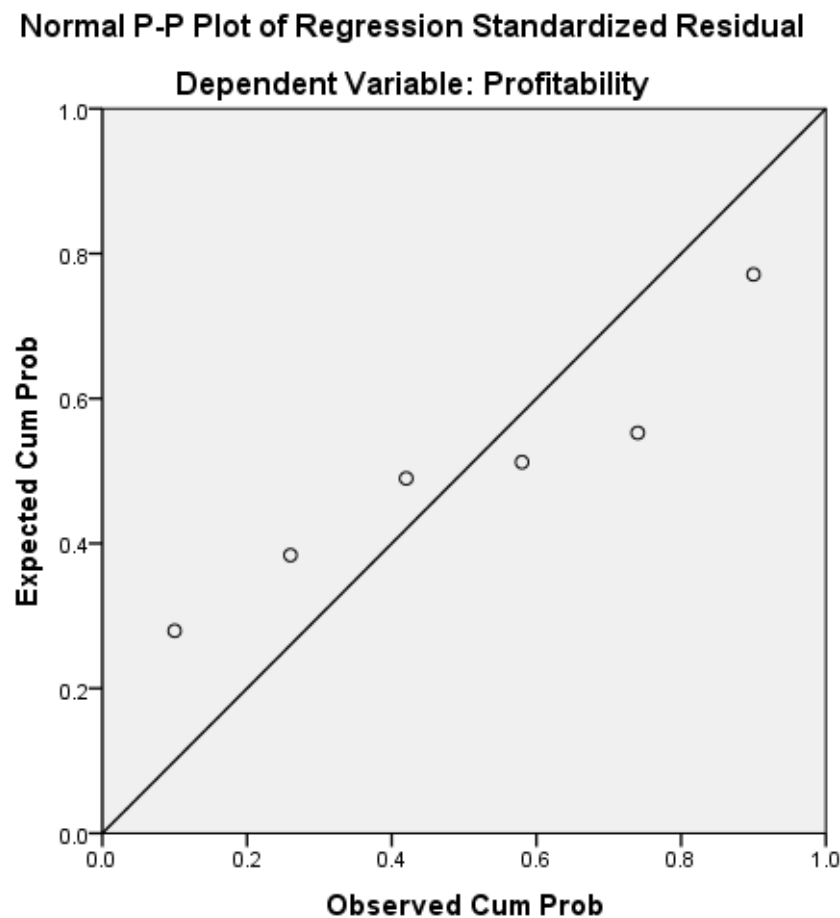
a. Dependent Variable: Profitability

From table 4.6 Babove, collinearity statistics indicated that tolerance statistics for short term debt (STD), long term debt (LTD), retained earnings (RE) and share capital (SC) were 0.560, 0.960, 0.272 and 0.390 respectively. On the other hand, Variable inflation Factor (VIF) of short term debt (STD), long term debt (LTD), retained earnings (RE) and share capital (SC) were 1.785, 1.042, 3.673 and 2.562 respectively. However, the thumb rule is that tolerance statistic must be greater than 0.2 and VIF must be less than 10 since a VIF greater than 10 is unsatisfactory and that independent variable must be removed from analysis when ascertaining multicollinearity of independent variables. From the above collinearity statistics, tolerance values of short term debt (STD), long term debt (LTD), retained earnings (RE) and share capital (SC) are more than 0.2 and their VIF on the other hand are less than 10 implying that these independent variables are highly correlated in contributing towards financial performance of commercial banks listed on USE.

4.7.3 Linear relationship

This assumption was examined to test if the dependant variable (outcome variable) have a rough linear relationship with each of the independent variables. This was tested using the Normal P-P plot in figure 4.1.

Figure 4.1: Normal P-P plot showing linear relationship



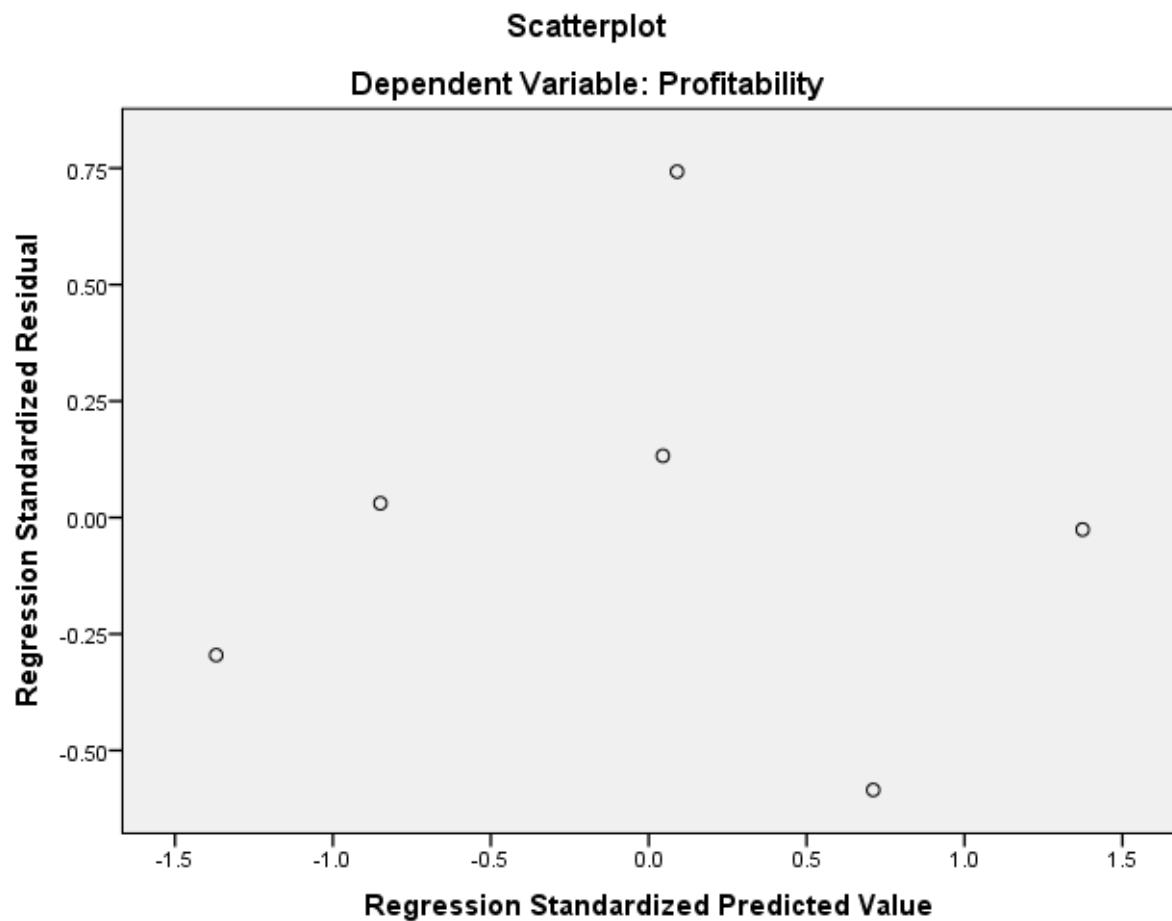
Source: SPSS Output, 2017

From the figure 4.1 above, it is indicated that dots are generally following the diagonal line and this implies that there is linear relationship between the capital structure and financial performance proxy, which is profitability.

4.7.4 Homoscedasticity and normally distributed residuals

These assumptions were examined by generating a scatterplot as shown in figure 4.2.

Figure 4.2: Scatterplot showing homoscedasticity and normally distributed residuals



Source: SPSS Output, 2017

From figure 4.2 above, the dots are scattered over the scatterplot. This indicates that variances of residues are constant which implies that the assumption of homoscedasticity was met. Also the dots are normally distributed which therefore meets the assumption of normally distributed variables.

4.8 Relationship between capital structure and financial performance

The following table shows the relationship between capital structure and financial performance proxy that is profitability.

Table 4.7: Pearson linear correlation coefficient

		Capital Structure	Financial performance
Capital Structure	Pearson Correlation	1	-.421
	Sig. (2-tailed)		.406
	N	6	6
Financial performance	Pearson Correlation	-.421	1
	Sig. (2-tailed)	.406	
	N	6	6

Panel data of five selected commercial banks listed on Uganda securities exchange for six-year period of 2010-2015 were analysed about capital structure and financial performance and the Pearson's r data analysis revealed a moderate negative correlation, $r = -0.421$. This implies that capital structure of selected commercial banks listed on Uganda securities exchange have a statistical significant negative effect on financial performance proxy of profitability.

4.9 Hypotheses testing

Decision Rule: Reject the Null hypothesis if the P-Value obtained using SPSS is less than 0.05 which is the alpha level of significance specified in SPSS for this analysis. But if otherwise, then do not reject the null hypothesis.

H_{01} : There no significant relationship between short term debt financing and financial performance of selected commercial banks listed on Uganda Securities Exchange. The researcher accepted the null hypothesis because the p-value (p-value = 0.710) of short term debt financing and financial performance is greater than 5% ($\alpha = 0.05$) level of significance.

H_{02} : There is no significant relationship between long term debt financing and financial performance of selected commercial banks listed on Uganda Securities Exchange. The researcher accepted the null hypothesis because the p-value of long

term debt financing and financial performance was 0.523 which is greater than 5% level of significance.

H₀₃: There is no significant relationship between retained earnings and financial performance of selected commercial banks listed on Uganda Securities Exchange. The researcher accepted the null hypothesis since p-value of 0.483 is greater than the level of significance ($\alpha = 0.05$).

H₀₄: There is no significant relationship between shareholder's capital and financial performance of selected commercial banks listed on Uganda Securities Exchange. The researcher accepted the null hypothesis since p-value of 0.128 is higher than the level of statistical significance ($\alpha = 0.05$).

CHAPTER FIVE

DISCUSSION OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

Under this chapter, in accordance to the research objectives of the study, the researcher discussed and gave conclusion to the major findings of the study. The researcher also presented recommendations for the study and these were also in accordance to the research objectives. Based on the recommendations, areas for future research were also presented.

5.2 Discussion of findings

5.2.1 Effect of short term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The study found out that short term debt positively and insignificantly affects financial performance of commercial banks listed on Uganda Securities Exchange. This was consistent with Palombini and Nakamura (2012) who found out that short-term debt is positively related to financial performance. The finding also was in disagreement with Benmelech and Dvir (2013), who stressed that short term debt helps to meet immediate need for financing without long term commitment and the cost of servicing short term debt is less taxing on the company whereby short term loans usually offer lower interest charges, and most lenders do not charge interest until all credit allowance period is breached. The finding was contrary to El-Sayed Ebaid (2009) who found out that short term debt negatively affects financial performance of companies listed on the Egyptian Stock Exchange. Furthermore, this was in disagreement with Zeitun and Tian (2014) who argued that short-term debt influences a firm's financial performance negatively, because short-term debt exposes firms to the risk of refinancing.

5.2.2 Effect of long term debt financing on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The study found out that long term debt financing positively and insignificantly affects financial performance of selected commercial banks listed on Uganda Securities Exchange. This was in agreement with Kyereboah and Coleman (2007), who found out that long term debt positively and significantly impacts on financial performance of MFIs. Kyereboah and Coleman (2007), further suggest that profitable MFIs depend more on long term debt financing. This was further supported by Amidu (2007) who observed a positive association between long-term debt and firm's financial performance. This was further in agreement with El-Sayed Ebaid (2009) who found out that there was no significant relationship between long term debt and financial performance.

5.2.3 Effect of retained earnings on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The study found out that retained earnings are negatively and insignificantly related to financial performance of selected commercial banks listed on Uganda Securities Exchange. This was in disagreement with Khan, Zulfiqar and Shah (2012) who found out a weak positive relationship between a firm's retained earnings and financial performance in Pakistan. Also the finding was in disagreement with Khan (2012) who found out that retention ratio has significant positive relation with financial performance and significantly explains the variations in the stock prices of chemical and pharmaceutical sector of Pakistan. In addition, the finding disagreed with Khan (2012), who further stressed that the prime idea behind earnings retention is that the more the company retains, the faster it has chances for growth.

5.2.4 Effect of shareholders' capital on the financial performance of selected commercial banks listed on Uganda Securities Exchange

The study found out that shareholder's capital is negatively and insignificantly related to financial performance of selected commercial banks listed on Uganda Securities Exchange. This was in disagreement with Booth *et al.*, (2002) and Nunkoo

and Boateng (2010) who found out that use of equity capital is positively related to the financial performance of firms. In addition, the finding was contrary to Shubita and Alsawalhah (2012) who found out that equity capital financing has a positive relationship to financial performance. And finally, the finding was contrary to Shubita and Alsawalhah (2012) who suggest that firms with high profits depend heavily on equity capital as their main financing option.

5.3 Conclusions of the study

The main purpose of the research was to establish the relationship between capital structure and financial performance of commercial banks listed on Uganda Securities Exchange and the conclusions were based on research objectives of the study.

According to the findings, short term debt has a positive insignificant effect on financial performance of commercial banks listed on Uganda Securities Exchange. Thus, an increase in short term debt increases the financial performance of selected commercial banks listed on Uganda Securities Exchange, whereas a decrease in short term debt of selected commercial banks listed on Uganda Securities Exchange decreases their financial performance.

According to the findings, long term debt financing has a positive insignificant effect on financial performance of selected commercial banks listed on Uganda Securities Exchange. Therefore, an increase in long term debt increases the financial performance of selected commercial banks listed on Uganda Securities Exchange and a decrease in long term debt decreases their financial performance.

According to the findings, retained earnings have a negative insignificant effect on financial performance of selected commercial banks listed on Uganda Securities Exchange and thus, an increase in retained earnings decrease the financial performance of selected commercial banks listed on Uganda Securities Exchange, whereas a decrease in retained earnings lead to an increase in the financial performance of selected commercial banks listed on Uganda Securities Exchange.

From the findings, it was concluded that shareholder's capital has a negative insignificant effect on financial performance of selected commercial banks listed on Uganda Securities Exchange. Thus, increase in shareholder's capital decreases financial performance of selected commercial banks listed on Uganda Securities Exchange and a decrease in shareholder's capital increases financial performance of listed commercial banks.

5.4 Recommendations

Based on the research objectives of the study, the following recommendations were suggested by the researcher;

The management of each selected commercial bank listed on USE should consider the use of more short term debt in their capital structure mix as this will enable these banks to increase their financial performance;

Further, the financial managers of each selected commercial bank listed on USE should use more of long term debt in their capital structure mix since long term debt has a positive effect on financial performance. This will increase their financial performance. However, financial managers should employ long term debt as the last resort;

Management of each selected commercial bank listed on USE should decrease the use of retained earnings in financing their overall operations to increase their financial performance; and

Finally, each selected commercial bank listed on USE should decrease the use financing their overall operations and growth using share capital as a component of their capital structure since an increase of share capital decreases financial performance.

5.5 Contribution to knowledge

The study revealed that there are other variables apart from capital structure constructs that contribute towards the financial performance of commercial banks.

Among these is size of the bank and growth opportunities. Also to the management level, the study developed great ideas that the management of the commercial banks should have priorities set to meet their objectives as these among others affect their financial performance. The society was versed with knowledge on uninterpreted figures of selected commercial banks that has made clear analysis for them to clearly know how their commercial banks are performing financially. In accordance to research gap, the study clearly discussed constructs of independent and dependent variables. Also the study elaborated more with illustrations and clear explanation on the use of panel data in coming up with valid conclusions to the study.

5.6 Areas for future research

Although it was found out that short term debt has an insignificant positive effect on the financial performance of selected commercial banks listed on USE, further research should be conducted on the effect of short term debt on financial performance of each commercial bank listed on USE by employing data from a larger sample for a longer period to confirm these findings. Furthermore, future research should be conducted on effect of long term debt, retained earnings and share capital on financial performance of each selected commercial bank by employing data from a larger sample to confirm the findings.

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APPENDIX A

RAW PANEL DATA

Bank	Year	Long Term	Short Term	E.A.I.T	N.I.I	Total Assets	Total liabilities	Share capital	Retained	Total Equity
		Debt	Debt						Earnings	
BARODA	2010	105,327,137	306,019,522	21,229,338	29,227,748	496,449,244	411,346,659	14,852,266	70,250,319	85,102,585
EQUITY	2010	82,808	33,006	7,132	11,713	143,018	115,814	13,038	11,204	27,204
KCB	2010	5,958,787	206,267,642	7,177,973	19,645,325	251,356,200	212,226,429	21,488,768	13,953,178	39,129,771
DFCU	2010	159,371	552,407	23,056	60,275	802,380	711,778	22,380	58,981	90,602
STANBIC	2010	50,378,000	2,119,682,979	72,081,980	172,709,401	2,400,147,765	2,170,060,979	21,761,626	172,325,160	230,086,786
BARODA	2011	106,972,620	345,248,990	27,634,251	42,423,800	556,664,767	452,221,610	22,132,824	82,310,333	104,443,157
EQUITY	2011	111,188	50,821	10,325	16,223	196,294	162,009	12,863	17,719	34,285
KCB	2011	15,845,047	270,332,085	10,981,046	23,286,411	330,663,959	286,177,132	26,765,247	17,721,580	44,486,827
DFCU	2011	128,047	711,235	30,774	81,136	953,681	839,282	28,336	76,828	114,399
STANBIC	2011	55,590,000	2,362,661,800	121,701,729	249,817,471	2,713,235,272	2,418,251,800	1,534,001	243,449,471	294,983,472
BARODA	2012	185,635,106	388,440,916	29,400,199	51,974,521	708,739,066	574,076,022	23,493,288	111,169,756	134,663,044
EQUITY	2012	137,072	63,182	12,080	23,964	243,170	200,254	13,199	25,088	42,916
KCB	2012	13,739,366	299,984,360	12,203,531	30,636,232	368,018,785	313,723,726	25,419,747	28,875,312	54,295,059
DFCU	2012	201,806	663,752	30,617	83,505	1,001,339	865,558	31,972	94,587	135,781
STANBIC	2012	61,371,000	2,636,183,114	130,734,072	296,692,210	3,098,593,400	2,697,554,114	61,153,237	269,886,050	401,039,286
BARODA	2013	186,811,412	599,101,137	30,824,567	47,759,778	948,267,020	785,912,549	34,090,621	123,263,850	162,354,471
EQUITY	2013	151,683	74,491	13,278	26,491	277,729	226,174	13,339	32,662	51,555
KCB	2013	16,719,413	310,777,199	14,341,382	32,984,286	390,851,579	327,496,612	26,756,199	36,598,768	63,354,967
DFCU	2013	241,027	823,875	34,601	96,163	1,226,062	1,064,902	30,561	116,759	161,160
STANBIC	2013	66,583,000	3,175,015,040	101,851,527	247,757,588	3,241,598,040	3,241,598,040	56,113,806	299,194,691	405,308,497
BARODA	2014	134,897,738	807,256,467	36,808,367	57,960,866	1,135,852,235	942,154,205	34,952,351	152,495,679	193,698,030
EQUITY	2014	165,240	115,556	17,151	29,175	344,572	280,796	14,056	43,055	63,776
KCB	2014	16,693,037	398,011,730	16,848,862	35,951,396	490,338,324	414,704,767	29,293,510	46,340,047	75,633,557
DFCU	2014	224,784	1,008,417	42,109	103,289	1,424,742	1,233,201	35,890	143,951	191,541
STANBIC	2014	33,603,000	2,987,189,481	135,079,382	280,194,689	3,507,762,015	3,020,792,481	47,669,707	354,326,635	486,969,534
BARODA	2015	138,748,974	842,929,631	41,132,845	74,258,090	1,202,503,150	981,678,605	30,228,139	184,346,406	220,824,545
EQUITY	2015	210,010	145,916	17,327	33,922	428,062	355,926	11,729	52,216	72,136
KCB	2015	21,671,181	455,169,366	19,623,071	39,294,522	558,094,154	476,840,547	25,023,431	56,230,176	81,253,607
DFCU	2015	365,850	1,070,648	35,290	108,232	1,651,629	1,436,498	48,658	155,669	215,131
STANBIC	2015	183,281,000	3,001,102,269	150,759,281	311,480,031	3,729,141,013	3,184,383,269	55,151,322	449,606,422	544,757,744

Source: Panel data obtained from USE, 2015

APPENDIX B

TRANSMITTAL LETTER



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Directorate of Higher Degrees and Research
Office of the Director

Our ref. 1153-05026-03797

Friday 11th August, 2017

Dear Sir/Madam,

Re: Introduction Letter for Ayebazibwe Wilbert (1153-05026-03797)

The above mentioned candidate is a student of Kampala International University pursuing a Master's Degree in Business Administration (Finance and Administration).

He is interested in conducting a research for his dissertation titled, "*Capital Structure and Financial Performance of Selected Commercial Banks Listed in Uganda Securities Exchange*"

Your organization has been identified as a valuable source of information pertaining to the research subject of interest. The purpose of this letter therefore is to request you to kindly cooperate and avail the researcher with the pertinent information he may need. It is our ardent belief that the findings from this research will benefit KIU and your organization.

Any information shared with the researcher will be used for academic purposes only and shall be kept with utmost confidentiality.

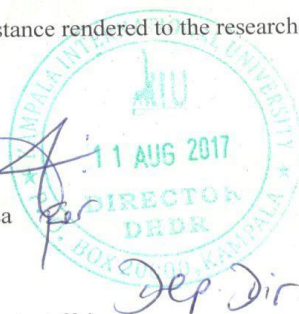
I appreciate any assistance rendered to the researcher

Yours Sincerely,

Dr. Claire M. Mugasa

Director

C.c. DVC, Academic Affairs



"Exploring Heights"