Financing decision: A vital key to explaining small and medium enterprises (SMEs) financial performance

Yusuf N. Katerega • Mohamed Ngoma • Ayub K. Masaba • Sudi Nangoli • Yusuf Waswa • Sophie Namiyingo

Makerere University Business School Kampala, Uganda.

*Corresponding author. E-mail: snangoli@mubs.ac.ug.

Abstract. This research focuses on financing decisions as a predictor of financial performance of small and medium size enterprises in Mbale District in Uganda. The study adopted a cross sectional survey involving a sample size of 341 SMEs in the categories of General merchandise, super markets, manufacturing, hotels and restaurants. Simple random sampling was used to select the 341 firms from the total population of 3,274 firms as the unit of analysis, the owners and senior staff were the unit of inquiry. One respondent was targeted per firm. Results of the multiple regression analysis revealed a significant positive relationship between financing decision of SME's and their financial performance, implying that financing decision is a significant predictor of financial performance of SMEs in Uganda. As small and medium enterprises continuously search for ways of improving their financial performance they should pay particular attention to professionalism and interest rates in their quest to boost financial performance.

Keywords: Financial performance, financing decision, small and medium enterprises, strategy.

INTRODUCTION

Good financial performance of SMEs provides the economy with a continuous supply of skills and innovative ideas necessary to promote competition and efficient allocation of scarce resources (Kasekende and Opondo, 2003). This is through their ability to grow and survive amidst all setbacks. Interest in the role of SMEs in the development process of most countries continues to be at the fore front of most policy debates (Abor, 2007). Governments at all levels have also undertaken initiatives to promote the growth of SMEs (Feeney and Riding, 1997). SMEs development is viewed as a way of accelerating the achievement of wider economic and socio-economic objectives, including poverty alleviation (Cook and Nixson, 2000). Financial performance therefore can be viewed as a measure of how well a firm can use assets from its primary mode of business and generate revenues, which can aide in fostering strategic developments (Dess and Robinson, 2003; Kaplan and Norton, 2004). Profit performance has been categorized to be the bottom line, which means financial performance of a company might be judged from the profit generating

potential of an organization (ACCA, 2006). However, different scholars use different measures of financial performance. For example, Carton (2004) looks at survival as a measure of financial performance which indicates if the organization remained in business over the time period of interest or the likeliness that the organization will continue in business in the future. Contrary to most empirical research in entrepreneurship and strategic management that address time horizons of five years and less, survival is rarely used as a measure of overall organizational performance. Spivey and McMillan (2002) look at profitability measures like earnings per share, net profit margin and return on capital employed; cash flow measures and growth measures as earnings growth and sales growth as measures of performance.

A number of factors would explain good financial performance of SME's like CEO's managerial characteristics (Lemon et al., 2008, Malmendier et al., 2010), management attitudes and behaviors (Odenge, 1996; Herbert and Yost, 1978). However, Romano et al.

(2000) argue that the financing decision or the choice of finance could impact on the firm's capital structure, growth opportunities, profit performance and long-term survival. Finance decisions involve any decisions made by managers that have any financial implications on the operations of the business (Rehman, 2013). It looks at the way companies build their optimal combination of debt - equity to finance their investments. Romano et al. (2001), in his study about the capital structure decisions of small businesses, found out that a large number of factors influence SME's financing decisions, more paramount is the firm owners' attitudes towards the utility of debt as form of funding. These findings are consistent with Malmendier et al. (2010) that measurable managerial characteristics have significant explanatory power for corporate financing decisions which decision in one year may lead to a weak firm performance which performance may again affect the firm's future access to finance (Huyghebaert, 2008).

Despite a number of studies revealing that financing decision has a direct contribution to the financial success of SMEs (Hutchinson, 1995; Sogorb-Mira, 2005; Degryse et al., 2009; Ndawula, 2013; Huyghebaert, 2008; Ajzen and Fishbein, 2005), anecdotal evidence in Uganda in general and Mbale district in particular still show that SMEs in Mbale District still fail to achieve their targeted profitability of between 40 and 60%, low survival and growth levels, majority of them are making little contribution as a result of achieving dismal growth in their businesses. It is estimated that 60% of SME's continue to register a sales turnover of less than one million shillings monthly, declining profits at a rate of 30 to 40% per annum and total bankruptcy of SMEs stands at 10% every year (District commercial officer report, 2011). This could be attributed to poor financing decision (Ssebatindira, 2009; BOU Report, 2010; Huyghebaert et al., 2004, 2007). For example, Bank of Uganda report (2010) cites that Stanbic Bank in 2010 secured 30 million US dollars credit, surprisingly only 17% of this fund was applied for by SMEs; this low response by SMEs may be attributed to negative attitude of managers regarding financing their investments using Debt sources and partially to the exorbitant charges by banks ranging from 18 to 40% (Ssebatindira, 2009). While earlier studies have attempted to examine the predictors of SME's financial performance using models outside Uganda (Ajzen and Fishbein, 2005; Gallup Organization, 2006; Franks and Sussman, 2005; Huyghebaert et al., 2007), little has been researched in Uganda in general (Kasekende and Opondo, 2003) and Mbale District in particular to validate these findings. Most of the research is provisional and subjective. The purposes of this research are to examine the relationship between firm financing decision and financial performance of small and medium enterprises to come up with implications for the region. The rest of this article is as follows, examination of the theoretical basis and reviews literature to develop hypotheses, followed by research methodology and results from data analysis. Implications, limitations and directions for future research are also provided.

LITERATURE REVIEW

Financing decisions involve any decisions made by managers that have any financial implications on the operations of the business. (Rehman, 2013), it looks at the way companies build their optimal combination of debt - equity to finance their investments. Most research on financing decision is rooted in how capital structure of firms is set up, mainly the proportion of debt to equity capital. The financing decision of a firm relates to the choice of the proportion of these sources to finance the investment requirements. Studies by Snyder (2000), Mutesasira et al. (2001), Stevenson and St. Onge (2005) and Uganda Bureau of Statistics (2003), established that the financing of SMEs in Uganda is mainly obtained from both the informal and formal sources, with informal sources play a leading role in availing funds to many SMEs, especially during the start-up phase. This was highlighted further by the Private Sector Foundation study (2005) which point out that informal financing arrangements are the most commonly used financing mechanisms for SMEs in Uganda. These involve use of personal sources, especially savings and reinvestment of profits, loans and grants from a social network of family and friends, liquidation of family assets, reciprocal asset usage arrangements, informal operating leases, rotating savings and credit institutions (Odenge, 1996). However, most commercial banks in Uganda have recently included SMEs into their portfolios through their micro lending schemes; mainly extending small business loans ranging from 70 US dollars to 7000 US dollars primarily for working capital purposes (B. O.U Report, 2010). Studies also show to the contrary that most SMEs still fail to qualify for credit under this opportunity because they find it difficult to meet stringent eligibility criteria, specifically collateral requirements making it hard for them to perform well financially (Kasekende and Opondo, 2003).

Alslehat and Altahtamouni (2014) in a study aimed at determining the casual relationship between financing decision and their impact on financial performance among Jordanian banks, the key results indicated that financing decisions are influenced by the return on assets among other factors, and that the greater the returns the more firms do not fear to go for external finance. However, in Uganda most SMEs are taken away from external financing due to high interest rates. Interest rates charged on loans often ranging from 22 to 30% on short term lending makes managers of SMEs have negative attitudes towards external financing of their businesses making them to restrict themselves to the narrow informal financial base which doesn't allow them to carry out all

their operations successfully, limiting their rapid performance and desire for quick expansion (Ssebatindira, 2009). Consistent with the Ministry of Finance, Planning and Economic Development (MFPED) working paper (2008), it still acknowledges interest rates being high by asserting that SMEs find it difficult to access financing partly due to lack of collateral to secure such loans but also banks consider most SMEs as high risk clients and this high risk is attributable to a number of factors including poor management skills, lack of collateral, uncertainty of their businesses and poor record keeping practices.

A study by Abor (2005) found a relationship among total debt and profitability to be positive because of the larger proportion of short term financing in total debt, but in the same study he emphasizes low interest rates has a major contributor to profitability. However, in his other study Abor (2007) on debt policy and performance of Medium Sized Enterprises in Ghana and South Africa, he found the effect of short-term debt to be Negative significant with gross profit margin meaning that increasing the amount of short-term debt would result in a decrease in the firm profitability. In agreement, Deesomsak et al., (2004) also found a negative relation of leverage level with firm performance, he further adds that when firms have a sizeable amount profits, they resort to use of internally generated source other than borrowing

Studies have also emphasized financing decision being an industry specific and country specific factors in influencing the optimal capital structure decisions (Seppa, 2008; Harkbarth et al., 2006; Huang and Song, 2006). They explain how firms first utilize internal funds to finance opportunities then move towards external source of financing. Further, large size firms also employ more external funds when internal funds are insufficient to finance opportunities (Seppa, 2008). Huang and Song (2006) shares an experience about Chinese companies being state controlled and prefer equity financing over debt financing because they still hold the controlling interest and weak laws exist to protect the rights of shareholders. Salazar et al. (2012) argues that some SMEs have further incorporated financing decision as a strategy to pursue competitiveness. Rehman (2013) introduces the concept of financial leverage in making financial decisions, that firms with lower leverage rates are much likely to pool together their profits and invest them in firm growth opportunities than spending it on settlement of debts, hence good performance. Harkbarth et al. (2006) brings in the aspect of countries economic fact. That decision about optimal leverage level is dependent on balancing the costs of debt and tax benefit attached to debt, depends on macroeconomic conditions of the country. A decision for firms to either go for debt or equity will depend on the whether the country is undergoing a recession or a boom. Meaning that the key relationship between financing decision and firm perfor-

mance is partly influence by the macro economic factors (Krishnan and Moyer, 1997). So under such circumstances what influences the decision of managers when choosing debt or equity or a mixture of both is way beyond internal firm environment? Influence on the leverage levels of the firm has also been seen as the conflict between various agency stakeholders arising from excessive debt which creates agency problems among shareholders and creditors and that could result in negative relationship between leverage and profitability hence negative significant impact on firm performance (Onaolapo and Kajola, 2010; Majumdar and Chhibber, 1999).

Research shows that there is a surplus of published work regarding financing on small and medium enterprises in relation to performance. Unfortunately, most of the studies on capital structures and performance are in Europe, Asia and very few were conducted in Africa and Uganda in particular (Seppa, 2008; Zeitun and Tian, 2007; Kinsman and Newman, 1999; Huang and Song, 2006; Ebaid, 2009; Deesomsak et al., 2004; Abor, 2007). It is thus clear that the existing studies have failed to integrate knowledge on financing decisions and financial performance the context of SMEs. Like it is argued by McLeod and Bandura (2011), that study results are always influenced by research environment in his social cognitive theory. It is imperative, therefore, to conduct a study that will bring an understanding of the effect of financing decision on Small and medium enterprise's performance in a developing world context.

METHODOLOGY

Research design

The study adopted a cross sectional survey design. Correlation and regression approaches were used to investigate the relationships between the variables and the extent to which the independent variable explains financial performance of SMEs in this region. The study population (N) comprised 3,274 registered Small and Medium enterprises according to District Commercial Officer report (2011). The study scope was limited to Mbale District which is one of the districts with the highest SMEs set-ups in Uganda. The sample size of 341 SMEs was targeted and arrived at basing on the Krejcie and Morgan Table of 1970, which gives a fair representation of the study population. However, of the 341 questionnaires administered 299 were obtained giving us about 87.7%. Simple random sampling was used to select the 341 firms from the total population of 3,274 firms as the unit of analysis, the owners and senior staffs were the unit of inquiry. One respondent was targeted per firm as adopted and used by Nguyen and Ramachandran (2006) which was deemed fit for the study. Based on the chosen sample, questionnaires were distributed to the

Table 1. Validity and reliability of variables.

Variable	N	Cronbach alpha coefficient	Content validity index
Firm financing decisions	15	.817	.800
Financial performance of SME's	15	.805	.867

Table 2. Nature of the business.

Nature of the business	Count	Valid percent	Cumulative percent
General merchandise	76	25.4	25.4
Supermarkets	49	16.4	41.8
Hotels and restaurants	69	23.1	64.9
Manufacturing	45	15.1	79.9
Others	60	20.1	100.0
Total	299	100.0	

manager or firm owners who are always involved in making financing decision.

Measurement of variables

With the review of existing literature, measurement of variables was on the basis of previous studies; measurement items were improved to be consistent and suit the study. Respondents assessed financing decision and financial performance on a 5-point Likert scale developed by Rensis Likert in the 1930s, ranging from 5 = Strongly Agree, 4 = Agree, 3 = Somehow Agree, 2 = Disagree, to 1 = Strongly Disagree. Financing decision was sub divided into three elements: interest rates, ownership control and management professionalism. Each dimension was measured based on the works of other scholars (Kamukama et al., 2011). Financing decision was measured in terms of ownership control (Huyghebaert, 2008), interest rates and management professionalism (De-Jong et al., 2006). Financial performance of SMEs was measured in terms of survival, profitability, sales growth and liquidity (Carton, 2004).

Validity and reliability

The validate and reliability analysis was conducted by calculating the content validity index (CVI) and Cronbach's coefficient for each dimension of financing decision and financial performance respectively The validity test results were all above 0.80, and above 0.70 deemed adequate (Anastasi, 1982). Reliability results for all the constructs also well exceeded the recommended decisive position of 0.70 (Hair et al., 2009) as shown in Table 1.

Data collection

Data was collected through administering questionnaires.

The questionnaires contained structured questions relating to the study variables financing decision and financial performance of SMEs which were set up on an interval scale with respondents answering in line with the extent to which they strongly agree, agree, don't know, disagree and strongly disagree with the statements in the questionnaire. Brief and to the point questions were designed, addressing only a single issue at a time and avoiding expressions that could bring out unacceptable responses. Each dimension was measured by at least five questions that were relevant in term s of prior research ambiguous and vague questions were either improved or deleted. Following the guidelines by Dillman (1991), the questionnaires also contained a heading clearly informing respondents that results would be completely anonymous as a means of seeking for honesty and avoiding exaggeration while answering.

RESULTS

Sample characteristics

Data received from 87.7% of firms that responded, included sample features of the respondents in terms of their personal and general business information considered important, this included. Nature of business, period of existence of the business, capital invested and the number of employees in the organization (Tables 2 to 5). Cross tabulations were used to indicate variations in the respondents' characteristics.

Nature of business

As shown in Table 2, findings on the nature of business engaged in by the respondents was aimed at establishing the type of business that most people are engaged in Mbale District, results indicated that the majority of the

Table 3. Period of business existence.

Period for which the business existed	Count	Valid percent	Cumulative percent
Less than 1 year	10	3.3	3.3
1 - 2 years	42	14.0	17.4
2 - 3 years	71	23.7	41.1
3 - 5 years	76	25.4	66.6
5 years and above	100	33.4	100.0
Total	299	100.0	

Table 4. Amount of capital invested by the business.

Amount of money invested in the business	Count	Valid percent	Cumulative percent
Less than 5 million	64	21.4	21.4
5 - 20 million	69	23.1	44.5
20 - 40 million	70	23.4	67.9
40 - 60 million	50	16.7	84.6
60 and above	46	15.4	100.0
Total	299	100.0	

businesses were engaged in the General Merchandise trade (25.4%) while those in Hotels and Restaurants business had the second biggest representation (23.1%). This was followed by those of the others none categorized businesses (20.1%), followed by supermarkets (16.4%). It should be noted that businesses in the manufacturing sector, constituted the smallest percentage (15.1%).

Period of existence

Findings on period the business has existed, aimed at showing the length of time the business has survived in the district given the that anecdotal evidence in Mbale as district and Uganda as a country, shows that most SMEs do not survive to celebrate their 2nd "birthdays" so this would help us ascertain how long the business have been in existence. Results indicated that most businesses had existed for a considerable period of 5 years and above (33.4%), followed by those that had existed for a period between 3 and 5 years (25.4%), followed by those of between 2 and 3 years (23.7%), followed by those that are between 1 and 2 years (14%) and finally those that are below 1 year (3.3%). These findings are depicted in Table 3.

Capital invested

Findings on the amount of capital invested by various SMEs and their distribution, show that majority of the firms invested between UGX 20 and 40 million (23.4%) and small number of firms invested above UGX 60 million shillings (15.4%), this generally guides us to a conclusion that most firms are still small and low capital firms as shown in Table 4.

Number of employees

The results showed that majority of the firms employed less than 20 people at a percentage of (45.5%), followed by those employed between 20 and 30 (24.2%), followed by those that employed between 30 and 40 in the third position (21.1%) and those that employed above 50 employees were the least (2.3%) meaning that most firm in the district are still very small, with low employing rates as has been indicated in Table 5.

Correlation analysis/zero order matrix

The study objectives involved examining the relationship between the study variables. The results in Table 6 showed a significant and positive relationship between the financing decision and financial performance (r = .622**, p < .01). This was also true for the relationships between the dimensions of professionalism of management (r = 0.552**, p < .01), interest rates (r = 0.362**, p < .01), ownership control (r = 0.438**, p < .01) and firm financial performance. These results show that if SMEs have clear corporate plans, aware of their financing needs and draft good financial plans, this brings about improvement in their growth ambitions, gaining good reputation amongst its customers and above all there will be general growth in the number of clients they serve.

Regression analysis

This model helped examine the degree to which the components of firm financing decisions can predict the

Table 5. Correlation analysis/zero order matrix.

	1	2	3	4	5	6	7	8	9
Professionalism of management - 5	.333**	.471**	.448**	.438**	1.000				
Interest rates - 6	.178**	.314**	.492**	.346**	.467**	1.000			
Ownership vontrol-7	.092	.330**	.275**	.247**	.419**	.261**	1.000		
Firm financing decisions - 8	.323**	.438**	.495**	.486**	.749**	.632**	.600**	1.000	
Financial performance of SME's - 9	.372**	.498**	.377**	.530**	.552**	.365**	.438**	.622**	1.000

** Correlation is significant at the 0.01 level (2-tailed). Source: Primary Data.

Table 6. Regression table.

Model	Unstandardized coefficients		Standardized coefficients	t	Sig.
	B	Std. error	Beta		
(Constant)	.314	.167		1.878	.061
Firm financing decisions	.471	.049	.478	9.550	.000

Dependent Variable: Financial performance of SME's

R	.675
R Square	.455
Adjusted R Square	.451
F Statistic	118.998
Sig.	.000

financial performance of small and medium enterprises, and results showed that financing decision predicted 45.1% of the variance in financial performance of SMEs (Adjusted R Square = .451). The remaining 54.9% was predicted by other factors outside the study. Financing decisions (Beta = .478, sig. < .01).with dimensions of interest rates, professionalism of management and ownership control was noted to be a better predictor of the financial performance. The regression model was also valid (sig. <. 01) (Table 6).

DISCUSSION

The purpose of this paper was to examine the relationship between managerial financing decisions and financial performance of Small and Medium Enterprises, and the extent to which financing decisions influence financial performance. Correlation results indicated a significant positive relationship between financing decision and financial performance; this signals the fact that if SMEs take proper decisions in financing their business activities, the overall growth of their business will be attained and good financial performance. All the dimensions of financing decision came up with a positive relationship with financial performance, specifically it was shown that lower interest rates foster profitability on the side of SMEs which is consistent with the finding of Abor (2005), while evaluating the relationship between profitability and capital structure for firms listed on the Ghana Stock Exchange and found a positive relationship for short term debt to total assets and return on equity

because of low interest rates. This is in agreement with findings that noted that, the ability of a firm to get a loan depends on how well the firm is able to service the debt and the abilities of its managers, which also depends on the net worth of the firm, such as the value of cash inflow and the liquid assets that the firm is able to generate which in turn will influence its capital base, growth and eventual financial performance. However, Ebaid (2009) noted that heavy industries have a positive relation with long term financing sources because of the large assets base employed by the firms.

Findings also show ownership control as a variable in influencing financing decision, having a small but a positive relationship with financial performance, the fear of loss of control pushes many SME owners to rely more on debt finance this is simply because its serves so much in controlling risks associated with equity sources, though it stops them from exploring other sources, that may contribute to growth. Studies by Myers (1977) argued that ownership control brings about firm owners sticking to short-term debt ratio which might actually be positively related to growth rate in a short run, but for a growing firm, substituting short-term financing for long-term financing becomes inevitable. Petersen and Rajan (1995), however, noted that the SMEs' smaller size, lack of credit ratings, along with concentration of ownership and control in the entrepreneur's hands, increase information asymmetries, preventing firms from attaining better funding terms and conditions in the capital market, which affects their survival (Ndawula, 2013).

In Uganda, there is clear need for SME owners and managers to adopt appropriate financial behaviors as

regards deciding which financing decision to undertake. Results of the analysis revealed that there was a clear positive relationship between financing decision and financial performance, and financing decisions made become clear predictors of good financial performance. However, due to lack of professionalism, SMEs take on wrong decisions, by asking for credit in critical times when businesses are struggling making it hard for them to repay the borrowed funds forgetting that banks are fierce liquidators following default, this has jeopardized their long term survival (Huyghebaert et al., 2007)

Conclusion

From the study results and the subsequent discussion, a significant positive relationship between financing decision and firm financial performance was proved. Financing decision rudiments (management professionalism, and interest rates) proved to be significant predictors of financial performance. This implies that SMEs managers should have clear business plans, become aware of their financing needs and draft good financial plans; this brings about improvement in their growth ambitions, gain good reputation amongst their customers and growth in the number of clients they serve.

Managers are very optimistic about their business success, with high commitment levels they are likely to take up the best balancing of debt and equity which will move their businesses to the next level. There is also a clear need for SME managers to have positive attitudes, mind their behavioral characteristics while balancing the debt equity decisions of the firm. In doing this they will become innovative, proactive and calculated risk takers, hence helping them realize good financial performance of their businesses.

RECOMMENDATION

From the regression analysis, results showed a positive relationship between financing decision and financial performance. In order for Small and Medium enterprises to grow and improve on their financial performance, there is clear need for their managers to adopt appropriate financial behaviors as delineated in the discussion above.

SME owners should orient their employees on how financing is done of major activities in the firm, draw clear plans, involve key employees in financial planning process, make general review of the business plan and also conduct awareness campaigns of the current financial stand of the business rather than keep issues of finance a secret to key employees.

In addition to orienting employees, SME managers should endeavor to join trainings and research activities to gain the needed knowledge in finance and business management, improve their professionalism, create

appropriate incentive structures to change their employee attitudes towards a common firm goal all this will offer them a competitive edge and build a good reputation for their firm which in turn will turn into good financial performance

Limitations of the research

Despite key findings of study as regards the financing decision, the study also faced some limitations ranging from the data collection instrument being a standard questionnaire which limits the ability to collect views about information outside asked question. The target respondents were so hard to access which impacted on the time taken in the field and the final response rate. Secondly the study used quantitative data other than qualitative data this limits in-depth interviews to solicit unstructured responses

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