THE IMPACT OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE
DECLARATION

I Amani Maila declare that this study is original and has not been published or submitted for any other degree award to any other university before.

Signed ........................................

Date ........................................
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ACKNOWLEDGEMENTS

First of all I thank the almighty God for I have been able to accomplish this study despite of lots of difficulties.

Let me take this opportunity to acknowledge my supervisors Mr. Haruni Mapesa for the assistance rendered in making this work a reality. His corrections, insights and encouragement are indeed invaluable to me. Secondly let me recognize the commitment of MS. J Myava who has been very instrumental in shaping this study. You tirelessly made yourself available to supervise, correct and offer additional advice. I cannot thank you both enough.

I thank my family for being very supportive to me during the period I was carrying out this study.
DEDICATION

I dedicate this work to my lovely mother, Mrs. A Maila, who gave me strength and support in the course of conducting the study. I dedicate this work to my lovely dad, the late Mr. J. S Maira, who believed in me and whose dream was to see me succeeding in both my study and career, may God rest him in eternal peace. I also dedicate this work to my uncle, eng. Naftali Chabwi for his financial support during the entire period of studies. Last but not least, I dedicate this work to all of my loyal friends who dedicated their time for assistance in any way.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>CAPM</td>
<td>CAPITAL ASSET PRICING MODEL</td>
</tr>
<tr>
<td>DE</td>
<td>DEBT EQUITY (CAPITAL STRUCTURE)</td>
</tr>
<tr>
<td>DFL</td>
<td>DEGREE OF FINANCIAL LEVERAGE</td>
</tr>
<tr>
<td>DOL</td>
<td>DEGREE OF OPERATING LEVERAGE</td>
</tr>
<tr>
<td>DSE</td>
<td>DAR ES SALAAM STOCK EXCHANGE</td>
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<tr>
<td>D/E</td>
<td>DEBT EQUITY RATIO</td>
</tr>
<tr>
<td>EPS</td>
<td>EARNINGS PER SHARE</td>
</tr>
<tr>
<td>NPV</td>
<td>NET PRESENT VALUE</td>
</tr>
<tr>
<td>NP</td>
<td>NET PROFIT</td>
</tr>
<tr>
<td>ROA</td>
<td>RETURN ON ASSET</td>
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<tr>
<td>ROCE</td>
<td>RETURN ON CAPITAL EMPLOYED</td>
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<tr>
<td>ROE</td>
<td>RETURN ON EQUITY</td>
</tr>
<tr>
<td>ROI</td>
<td>RETURN ON INVESTMENT</td>
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<tr>
<td>WACC</td>
<td>WEIGHTED AVERAGE COST OF CAPITAL</td>
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ABSTRACT

The main purpose of this study was to explore the impact of capital structure (DE ratio) on financial performance of the firm, a case study of CRDB bank PLC Mwanza branch. The relation between return on equity (ROE) and capital structure, return on asset (ROA) and capital structure, earnings per share (EPS) and capital structure, as well as net profit margin (NP Margin) and capital structure for CRDB bank PLC for the previous fifteen years, 1998 to 2012 were investigated.

To a great extent, the researcher did use secondary data. It is where by the financial statements of CRDB for the previous fifteen consecutive years, alongside with other relevant publications were acquired by the researcher for analysis. This enabled the researcher to have the basis for comparison as to the financial performance of CRDB from one financial period to another in relation to its capital structure for the corresponding periods. For that case, most of the data were quantitative based. On the other hand, primary data were used to a small extent. This was achieved mainly through interviews with CRDB bank staff members. However the impact of primary data as gathered from interviews and other explanatory variables was held constant as control variables. Only the impact of capital structure was analysed.

The data collected was processed and analysed descriptively by the use of tables, graphs, charts as well as the computerized data processing package known as SPSS. Regression analysis was run so as to find out the extent in which one variable explains the other. After a thorough analysis, conclusion was derived which details that the capital structure of CRDB bank has insignificant impact on financial performance, as measured by such particular comparable ratios.

Finally recommendations were made as regards to the impact of capital structure on financial performance, as well as to the optimum level of capital structure through which CRDB bank can improve its financial performance.
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CHAPTER ONE

INTRODUCTION

1.1 Background of the Problem

To understand how companies finance their operations, it is necessary to examine the determinants of their financing or capital structure decisions. Company financing decisions involve a wide range of policy issues. At the private, they have implications for capital market development, interest rate and security price determination, and regulation. At the private, such decisions affect capital structure, corporate governance and company development (Green, Murinde and Suppakitjarak, 2002). Knowledge about capital structures has mostly been derived from data from developed economies that have many institutional similarities (Booth et al., 2001). It is important to note that different countries have different institutional arrangements, mainly with respect to their tax and bankruptcy codes, the existing market for corporate control, and the roles banks and securities markets play. Capital structure refers to a mixture of a variety of long term sources of funds and equity shares including reserves and surpluses of an enterprise. The historical attempt to building theory of capital structure began with the presentation of a paper by Modigliani & Miller (1958). They revealed the situations under what conditions that the capital structure is relevant or irrelevant to the financial performance of the listed companies. Most of the decision making processes related to the capital structure are deciding factors when determining the capital structure, i.e. the determinants of capital structure, a number of issues such as cost, various taxes and rate, interest rate have been proposed to explain the variation in financial leverage across firms (Van Horne,1993; Hampton,1998; Titman and Wessels,1998). These issues suggested that depending on attributes that caused the cost of various sources of capital the firm’s select capital structure and benefits related to debt and equity financing. The relationship between capital structure and financial performance is one that received considerable attention in the finance literature. How important is the concentration of
control for the company performance, or the type of investors exerting that control are questions that authors have tried to answer for long time. Prior studies show that capital structure has relating with corporate governance, which is the key issue of state owned enterprises. To study the effects of capital structure or financial performance, will help us to know the potential problems in performance and capital structure.

1.2 Historical Background of CRDB Bank Plc

CRDB Bank Plc is a leading, wholly-owned private commercial bank in Tanzania. The bank was restructured in 1996 and nowadays it offers a comprehensive range of Corporate, Retail, Business, Treasury, Premier, and wholesale microfinance services through all over the year with a network of more than 72 branches, 5 agencies, more than 175 ATMs, 10 Depository ATMs, 5 Mobile branches, above 500 POS (Point of Sale) terminals, 450 Microfinance partners, as well as internet banking and Mobile banking. In early 2009, the bank announced plans to enter neighboring countries by establishing subsidiaries in Kenya, Uganda, Rwanda and Burundi.

In 1996, the CRDB Bank Ltd Tanzania decided to establish departments/sections, which deals with provision of financial services to the economically deprived people within the community. These departments/sections are called Business Banking Department and Personal Banking Department respectively. Business Banking is for Companies which applied for loan and Personal Banking Department for Individuals who applied for loans. These provide loans to the people who are active but with too meager resources that are not adequate to create enough wealth to sustain their lives or improve the quality of their lives.

CRDB Bank Ltd provides working capital to the reproductive poor so as to improve their economic well-being and dignity. This is in recognition of the fact that the poor had few options for credit as they cannot access credit from formal financial institutions due to lack of collaterals. The Bank business targets the economically disadvantaged or marginalized segment of the population for its services.
While CRDB Bank Ltd is devoted in assisting by providing loans, in many cases the people had failed to repay back their loans due to various problems facing them within the Community. The problem of clients failing to repay back their loans has an adverse effect on development and substantially of Financial Institutions. Due to these problems various Financial Institutions and researchers have started commissioning researches whose aim is to see how best they can do in order to make their service provision efficient and attractive.

CRDB Bank Ltd has taken various steps to ensure that their loans are repaid on time. Some of these steps include; Educating the clients on the importance of repayment of debts, strong supervision of the clients after they have obtained loans, penalize them on the amount outstanding and thorough analysis of the viability of the projects for which loans are sought. CRDB website (2012).

Ownership
CRDB Bank PLC is owned by institutions and private individuals as detailed in the table below:

Table 1: CRDB Bank PLC Stock Ownership

<table>
<thead>
<tr>
<th>Rank</th>
<th>Name of owner</th>
<th>Percentage of ownership (100%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Private individuals via DSE</td>
<td>37.0%</td>
</tr>
<tr>
<td>2</td>
<td>DANIDA</td>
<td>30.0%</td>
</tr>
<tr>
<td>3</td>
<td>Tanzania cooperation’s</td>
<td>14.0%</td>
</tr>
<tr>
<td>4</td>
<td>Tanzania Institutions</td>
<td>10.2%</td>
</tr>
<tr>
<td>5</td>
<td>Government of Tanzania</td>
<td>8.8%</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: CRDB website, 2012
CRBD Bank PLC’s vision

CRDb Bank PLC aspire to provide financial and non-financial services throughout Tanzania targeting people of bottom of banking pyramid so as to cultivate them into CRDB Bank customers and include them in the country’s financial system.

CRDB Bank PLC’s mission

CRDB Bank PLC is a market leader in wholesale microfinance, providing a wide range of needs driven financial and non-financial services to retail financial intermediaries using a motivated, knowledgeable, and skilled workforce. We will operate commercially adding volume of business to holding company from a market segment previously impossible to harness with normal banking system.

1.3 Statement of the Problem

Capital structure is most significant discipline of company’s operations. Firms performance as measured from Return on Assets (ROA), Return on Investment, Return on Equity, gross profit and net profit, are frequent times observing some variations. Such variations may reflect the increase or decline of such a firm’s financial performance. This can be observed by making comparison, either by the firm itself making a trend analysis to compare its current financial performance from the previous years, or by comparing its performance with other firms of the same industry. Theory predicts that a firm can increase its performance at its optimum level if the firm uses capital structure in effective and efficient way. Frank & Goyal (2009), the capital structured can also sometimes leads to the bankruptcy and has a negative and adverse effect on the performance of the firm if not properly utilized. Eric Rasmussen (2007), if firm performance affects the choice of capital structure, then failure to take this reverse causality into account may result in regression of a firm performance. Thus it is necessary to find out whether or not there is an optimum level of capital structure through which a firm can increase its financial performance more efficiently and
effectively, that is to determine whether or not there is a significant impact of debt equity ratio on the financial performance of a firm.

1.4 Research Objectives

1.4.1 General Objectives

The main objective of the study is to investigate the impact of capital structure on financial performance of a firm.

1.4.2 Specific objectives

a) To reveal the capital structure and financial performance of the bank.

b) To assess the determinants of capital structure.

c) To evaluate the relationship between capital structure and financial performance.

d) To determine an optimum level of capital structure through which a firm can improve its financial performance.

1.5 Significance of the study

The arrangement and decisions for the sources of finance as pertained to a particular firm is one of the key factors that can lead such firm to success or failure in the future. Hence this study will specifically have the following significance as far as capital structure is concerned;

a) Reflect the firm’s financial strategy.

b) Indicate the risk profile of the firm.

c) Act as a tax management tool.

1.6 Limitations of the Study

a) Time limitation will affect the researcher, from data collection towards data analysis.

b) Financial constraints due to limited resources by the researcher.
1.7 Delimitations

Due to limited time and financial constraints, the study will be restricted to Mwanza region only, with the researcher utilizing the time given much more efficiently and effectively.
CHAPTER TWO
LITERATURE REVIEW

2.0 General Introduction

Capital Structure

A firm’s capital structure refers to the mix of its financial liabilities. As financial capital is an uncertain but critical resource for all firms, suppliers of finance are able to exert control over firms. Debt and equity are two major classes of liabilities, with debt holders and equity holders representing the two types of investors in the firm. Each of these is associated with different levels of risk, benefits and control. While debt holders exert lower control, they earn a fixed rate of return and are protected by contractual obligations with respect to their investment. Equity holders are the residual claimants, bearing most of the risk, and, correspondingly have greater control over decisions.

Financial Performance

Financial performance refers to a firm’s level of profitability as measured through different financial ratios, such as return on asset, return on equity, gross profit, net profit. Normally the financial performance can be observed when there is the basis for comparison, such as the firm’s trends from past records.

Equity financing

When a firm doesn’t use debt financing, it is referred to as unlevered or ungeared firm Brigham (2004). If a firm doesn’t use debt then its return on invested capital shall be measured by return on equity which is denoted by net income to common stock holders divided by common equity.
Debt Financing

When a firm decides to use debt financing for its operations it’s faced with a financial risk and it’s referred to as a levered firm. Brigham & Houston, (2007) defined financial risk as that additional risk placed on common stock holders as a result of the decision to finance using debt. Financing risk is the probability that the earnings of the firm will not be as projected because of the method of financing. He also continues by saying that financing risk arises because debt has a fixed financing obligation usually in the form of interest which must be met when the obligation falls due before the shareholders can share in the retained earnings.

2.1 Theoretical Literature Review

Modigliani and Miller (1958) claim that under perfect capital market conditions, a firm’s value depends on its operating profitability rather than its capital structure. In 1963, Modigliani and Miller (1963) fix the previous paper; argue that, when there are corporate taxes then interest payments are tax deductible, 100% debt financing is optimal. This means that the firm’s value increases as debts increases.

Titman (1984) demonstrates the idea of indirect bankruptcy costs. He argues that stakeholders not represented at the bankruptcy bargaining table, such as customers, can suffer material costs resulting from the bankruptcy. Leland (1994) demonstrates a standard trade-off model. At the optimal capital structure, marginal bankruptcy costs associated with firm’s debt are equated with marginal tax benefits. The static tradeoff theory was the original retort to the theory of capital structure relevance. Modigliani and Miller (1963) argue that, when there are corporate taxes then interest payments are tax deductible, 100% debt financing is optimal. In this framework, firms target an optimal capital structure based on tax advantages and financial distress disadvantages. Firms are thought to strive toward their target and can signal their future prospects by changing their structure. Adding more debt increases firm value through the market’s perception of higher tax shields or lower bankruptcy costs. But optimal capital structure at a 100%
debt financing are clearly incompatible with observed capital structures, so their findings initiated a considerable research effort to identify costs of debt financing that would offset the corporate tax advantage.

Since then, extensions of the Modigliani-Miller theory have been provided by the following researches. Robichek and Myers (1965) argue that the negative effect of bankruptcy costs on debt to prevent firms from having the desire to obtain more debt. Jensen and Meckling (1976) identify agency cost in governing the corporation. The general result of these extensions is that the combination of leverage related costs (such as bankruptcy and agency costs) and a tax advantage of debt produces an optimal capital structure at less than a 100% debt financing, as the tax advantage is traded off against the likelihood of incurring the costs.

The strategic view of capital structure argues that managers actively seek to direct the firm’s capital structure to support the firm’s overall long term strategic goals, Barton & Gordon, (1987). There is partial evidence to support this analysis of capital structure. For example, Sandberg, Lewellen, and Stanley (1987) supported the idea that the firm’s level of debt is consciously selected by managers. Similarly, Balakrishnan & Fox (1993) found firm specific effects produced variances in firm leverage. However, while there is evidence that managers consciously select at least part of the firm’s capital structure, it has yet to be established what parameters direct the selection of the firm’s total capital structure.

Kraus and Lichtenberger (1973), the trade off theory of capital structure states that how much debt financed and equity finance is chosen by the company to use by balancing the cost and benefits. Capital structure is also called financial structure of a firm because it has the ability to meet the needs of its stakeholders. Roshan (2009), capital structure is very important for firm because it can maximise the stakeholders return. Moreover in dealing with the competitive environment an appropriate capital structure is also important to firm, Roshan (2009). Jenson and Meckling (1976) introduce the
concept of agency costs and investigate the nature of agency costs generated by the existence of debt and outside equity. The relationship between capital structure is non-linear. The association is found to be parabolic. Specifically the relationship is negative up to a certain point. Then it reverses and turns positive, Jiraporn (2005). The issue of optimal structure in the perfect market and in the imperfect market was explained by Raj S. Dhankar and Ajit. The single attempt that has been made to investigate whether strategic goals direct the firm’s capital choices examined the capital structure of 279 firms over four years, Barton & Gordon, (1988). This investigation found only partial support for the strategic perspective of capital structure with less than half of the authors’ nine hypotheses not being rejected. However, as will be detailed later in the paper this lack of results may have been due to methodological problems in the research.

Modigliani and Miller (1958) wrote a paper on the irrelevance of capital structure that inspired researchers to debate on this subject. This debate is still continuing. However, with the passage of time, new dimensions have been added to the question of relevance or irrelevance of capital structure. M&M declared that in a world of frictionless capital markets, there would be no optimal financial structure Schwartz & Aronson, (1979). This theory later became known as the 'Theory of Irrelevance'. In M & M's oversimplified world, no capital structure mix is better than another. M & M's Proposition-II attempted to answer the question of why there was an increased rate of return when the debt ratio was increased. It stated that the increased expected rate of return generated by debt financing is exactly offset by the risk incurred, regardless of the financing mix chosen.

Jensen and Meckling (1976) argue that the shareholders-lenders conflict has the effect of shifting risk from shareholders and of appropriating wealth in their favor as they take on risky investment projects (asset substitution). Hence, shareholders, and managers as their agents, are prompted to take on more borrowing to finance risky projects. Lenders receive interest and principal if projects succeed, and shareholders appropriate the
residual income; however, it is the lender who incurs the loss if the project fails. It is difficult and costly for debt holders to be able to assess and monitor such projects. Firms in an oligopolistic market will follow the strategy of maximizing their output in favorable economic conditions to optimize profitability, Brander & Lewis (1986). The theory also holds in unfavorable economic conditions; firms would take a cut in production and reduce their profitability.

Shareholders, though, while enjoying increased wealth in good periods, tend to ignore a decline in profitability in bad times. This is due to the fact that unfavorable consequences are passed onto lenders because of shareholders' limited liability status. Therefore, the oligopolistic firms, in contrast to firms in competitive markets, would employ higher levels of debt to produce more when opportunities to earn higher profits arise. The implied prediction of the output maximization hypothesis is that capital structure and market structure have a positive relationship. In corporate finance, the agency costs theory supports the use of high debt, and it is consistent with the prediction of the output maximization hypothesis.

Brander and Lewis (1986) and Maksimovic (1988) provide the theoretical framework that links capital structure and market structure. Contrary to the profit maximization objective postulated in industrial organization literature, these theories are similar to the corporate finance theory in that they assume that the firm's objective is to maximize the wealth of shareholders. Furthermore, market structure is shown to affect capital structure by influencing the competitive behavior and strategies of firms.

Omran (2001) evaluates the financial and operating performance of newly privatized Egyptian state-owned enterprises and determines whether such performance differs across firms according to their new ownership structure. The Egyptian privatization program provides unique post-privatization data on different ownership structures. Omran (2001) explained on his paper that, since most studies do not distinguish between the types of ownership, this paper provides new insight into the impact that
post privatization ownership structure has on firm performance. The study covers 69 firms, which were privatized between 1994 and 1998. For these newly privatized firms, these study documents significant increases in profitability, operating efficiency, capital expenditures, and dividends. Conversely, significant decreases in employment, leverage, and risk are found, although output shows an insignificant decrease following privatization. The empirical results also show that Egyptian state owned enterprises, which were sold to anchor-investors and employee shareholder associations, seem to outperform other types of privatization, such as minority and majority initial public offerings.

Despite these inconclusive results, strategic management researchers have increasingly demonstrated support for the concept of strategic capital structure. This support for the concept is illustrated by the efforts of strategy researchers to control for each firm’s long term financial structure in empirical analysis by utilizing systematic risk as a control variable, Miller & Bromiley (1990). However, an analysis of systematic risk, and in turn strategic capital structure, which emphasizes its control by firms, challenges some traditional financial viewpoints.

The strategic perspective argues that depending on the goals of the firm, and the disposition for risk by the firm’s managers in meeting those goals, that a firm’s capital structure will vary. However, it has typically been argued by those using the Capital Asset Pricing Model (CAPM) that the relevant measure of profitability is return adjusted to reflect the systematic risk. Thus, classic financial theory argues: since shareholders can manage systematic risk present in the financial market they should do so; the firm should not try to manage risk by varying its long term capital structure. But, Aaker and Jacobson (1987) demonstrated that systematic risk can impact the profitability of the firm and its strategic business units. They found that the impact of one unit increase in the systematic and business risk lead to significantly different levels of return. Thus, there is evidence of a potential benefit to firms from properly managing their systematic risk through their long term financial structure.
It is recognized that investors will try to control the risk present in their own portfolios, Hax & Majluf, (1984). However, it is not as well recognized that managers also have incentives to seek to control systematic risk of their firm’s stock. Portfolio theory builds on the assumptions that stockholders can fully diversify and that capital markets operate without imperfections such as transaction costs and taxes. But the reality is that many investors are not, or cannot afford to be, fully diversified. Additionally, transaction costs can act as an impediment to full diversification, Constantinides, (1986). Finally, there is evidence that firms can achieve reduction in systematic risk that the individual could not achieve on their own, Lubatkin & Chatterjee, (1994). Therefore, some investors will value control of systematic risk in a stock. If the investors do value such control, then managers can increase the attractiveness of their stock managers by controlling the risk their firm represents to the investors. If the stock is more attractive to investors it will allow the financial manager to reduce the cost of capital, specifically the cost of equity due to the increased capital from any new stock issued. Thus, again a benefit to the firm can occur from properly managing systematic risk.

Agency theory is another widely recognized theory in the finance literature but it is one largely ignored in regards to the development of a firm’s capital structure. The theory argues that managers will maximize their own wealth, Jensen & Meckling, (1976). It has been demonstrated that a determinant of a top manager’s compensation is the stability of the cash flows of the firm, Amihud & Lev, (1981). Thus, a manager may find it is desirable to have a stable cash flow over time rather than a cash flow which, while totally higher, has greater variability. The control of systematic risk can provide such stability of the cash flow. Also, it has been shown that the stabilization of cash flows helps to entrench managers in their positions and to make their removal less likely, Schleifer & Vishny, (1992); which again should encourage the manager to seek control of the systematic risk of the firm.
2.1.1 Determinants of Capital Structure

A number of empirical studies have identified firm level characteristics that affect the capital structure of firms. These include;

Asset structure

The asset structure of a firm plays a significant role in determining the firm’s capital structure. The degree to which the firm’s assets are tangible should result in the firm having greater liquidation value. Titman, (1988), Harris, (1991) assert that firms that invest heavily in tangible assets also have their financial leverage since they borrow at lower interest rate if their debt is secured with such assets. It is believed that debt may be more readily used if there are durable assets to serve as collateral, Wedig, Solan, Hassan & Morrissey, (1988).

Myers, (1999) suggested a positive relationship between asset structure and leverage (long term debt) for the firms, and a negative coefficient between depreciation expense as a percentage of total assets and financial leverage. However, Esperanca et al, (2003) also found a relationship between asset structure and both long term and short term debt. Thus the level of tangible fixed assets may help firms to obtain more long term debt.

Firm Age

As a firm continues to operate, it establishes itself as a going concern, thereby increasing its capacity to take on more debt. Hall et al, (2004) pointed that age is positively related to long term debt but negatively related to short term debt. Esperanca et al, (2003), found that age is negatively related to both short term and long term debt.
Firm Growth

According to Marsh, (1982), firms with high growth will capture relatively higher debt ratios. In the case of small firms with more concentrated ownership, it is expected that high growth firms will require more external financing and should display higher leverage, Heshmati, (2002). Myers, (1977) however, holds the view that firms with growth opportunities will have a smaller proportion of debt in their capital structure.

Firm Risk

Kale et al, (1991), risk levels are one of the primary determinants of capital structure of a firm. If a firm’s operating risk is more volatile than the firm’s earning stream, the chance of the firm defaulting and being exposed to bankruptcy and agency cost is high. Esperanca et al, (2003), found that there is positive relationship between firm risk and both long term and short term debts.

2.1.2 Cost of Capital

Cost of capital therefore in general summarizes the different costs attached to the different sources of financing obtained by an organization Michael (1992). Michael (1992) noted that for the case of equity financing, the shareholders will not often make explicit the return they will require for their capital contribution unlike the capital raised by way of borrowing which normally has an interest rate attached to it which then forms the basis of an organization's cost of capital. It is therefore imperative to note that a highly levered business depends more on debt for its overall financial capitalization which thereby increasing the risk hath to the debt and share holders.

Interest (cost of debt)

Pandey (2006) noted that a company could raise debt in a variety of ways which included borrowing funds from financial institutions or by way of public debt in the
form of bonds (debentures) for a specified period of time at a certain interest rate. The before tax cost of debt will therefore become the rate of return required by lenders.

**Dividends (cost of equity)**

When investors provide equity capital to a firm, they acquire a right to the future dividends of that firm given that they become partial owners of the company and that these dividends cannot be determined from the onset, Michael, (1992). Pandey (2006) noted that businesses have an option of raising capital internally by retaining earnings. The opportunity cost of retained earnings is the rate of return on dividend forgone by equity holders and the cost of external equity is the minimum rate of return which the shareholders require on funds supplied by them by purchasing new shares to prevent a decline in the existing market price of the equity share.

### 2.1.3 The Weighted Average Cost of Capital

The primary aim of management in a for-profit company should be to increase the wealth of the shareholders. For a given portfolio of projects and business operations, a company will maximise the wealth of its shareholders by minimising the company's weighted average cost of capital. This is because it will maximise the net present value (NPV) of all its project returns at a minimum cost of capital.

There are two main theories about the effect of changes in gearing on the weighted average cost of capital (WACC) and share values. These are the 'traditional' view, and the net operating income approach, for which a theoretical justification was provided by Modigliani and Miller (1958).

Both theories are based on some simplifying assumptions.

a) The company pays out all its earnings as dividends. (The theories ignore the impact of reinvesting profits to achieve profits and dividend growth in the future.)
b) The gearing of the company can be changed immediately by issuing debt to repurchase shares, or by issuing shares to repurchase debt. There are no transaction costs for these debt and equity transactions.

c) The earnings of the company are expected to remain constant in perpetuity and all investors share the same expectations about these future earnings.

d) Business risk is also constant, regardless of how the company invests its funds.

e) Taxation, for the time being, is ignored.

**The Traditional view of WACC**

The traditional view is that the WACC changes as gearing rises. Initially, the WACC falls with higher gearing, but then it starts to rise at gearing levels above the optimal capital structure. A graph showing the WACC at different gearing levels is therefore saucer-shaped. The optimal gearing level is at the point where WACC is minimised. The main points of the traditional theory of the optimal capital structure are therefore as follows.

a) As the level of gearing rises, the cost of debt remains unchanged, but only up to a certain gearing level. Beyond this level, the cost of debt will increase. The cost of debt increases at high gearing levels because the perceived default risk becomes more significant.

b) The cost of equity rises as the level of gearing increases. This is to compensate equity shareholders for the additional financial risk.

c) The weighted average cost of capital does not remain constant, but rather falls initially as the proportion of debt capital increases, and then begins to increase as the rising cost of equity (and possibly of debt) becomes more significant.

d) The optimum level of gearing is where the company's weighted average cost of capital is minimised.
The net operating income view of WACC

The net operating income approach takes a different view of the effect of gearing on WACC. A theoretical argument in favor of this view of capital structure was put forward by Modigliani and Miller, and is often referred to as 'MM theory'. However, the theoretical justification is not given here, only the conclusions.

According to this theory of capital structure, if tax relief on debt interest is ignored, the WACC is the same at all levels of gearing. As a consequence, the total value of the enterprise is the same at all levels of gearing.

a) The cost of debt remains unchanged as the level of gearing increases.

b) The cost of equity rises in such a way as to keep the weighted average cost of capital constant.

According to the net operating income view, a company is valued on the basis of its expected future earnings, regardless of how it is financed. The only matter of significance for gearing is how the 'cake' is shared between equity shareholders and providers of debt capital.

The Modigliani-Miller propositions

To set out the propositions of Modigliani and Miller, ignoring tax relief on the interest charged on debt capital, the following symbols are used.

Vu = the market value of an ungeared (all equity) company
D = the market value of the debt capital in a geared company which is similar in every respect to the ungeared company (same profits before interest and same business risk) except for its capital structure. The debt capital is assumed, for simplicity, to be irredeemable
E = the market value of the equity in the geared company
\[ K_{eu} = \text{the cost of equity in an ungeared company} \]
\[ K_{eg} = \text{the cost of equity in the geared company} \]
\[ K_d = \text{the cost of debt capital.} \]

The total market value of the geared company (\( V_g \)) is then equal to (\( E + D \)).

**Proposition 1 (ignoring taxation): the total market value of a company and the WACC**

MM suggested that the total market value of any company is independent of its capital structure, and is given by discounting its expected return at the appropriate rate. The value of a geared company is therefore as follows.

\[ V_g = V_u \]

\[ V_g = \frac{\text{Profit before interest}}{WACC} \]

\[ V_g = V_u = \frac{\text{Earnings in an ungeared company}}{K_{eu}} \]

**Proposition 2 (ignoring taxation): the cost of equity in a geared company**

MM went on to argue that the expected cost of equity in a geared company equals the expected cost of equity in a similar but ungeared company, plus a premium related to financial risk.

The premium for financial risk can be calculated as the debt/equity ratio multiplied by the difference between the cost of equity for an ungeared company and the risk-free cost of debt capital.
2.1.4 Factors affecting capital structure

The selection of financing methods for raising new capital will be influenced by a variety of factors.

a) Profitability

Retained profits are an important source of new funding, but these are available only to profitable companies.

b) The cost of capital

Companies should try to raise new finance at the lowest marginal cost. When there is a choice between debt and equity, one is likely to be a cheaper option than the other. The after-tax cost of debt finance is usually lower than the cost of equity, and it might therefore be supposed that companies will always prefer to raise new capital in the form of debt rather than equity. However, as the gearing ratio increases, existing equity investors might require higher returns to justify the increasing financial risk, and the overall effect of higher gearing might therefore be to increase the company’s cost of capital (it’s WACC). The relationship between financial risk and returns is explored in more depth later in this chapter.

c) The cost of raising funds

There are expenses involved in raising capital, such as fees to financial advisers and solicitors, and underwriting fees (for share issues). Some methods of raising finance are cheaper than others. For example, it is cheaper to raise new equity through a placing than through an offer for sale.
d) **Dilution of ownership**

Dilution of ownership occurs when the existing shareholders in a company suffer a reduction in the proportion of the total equity capital in the company that they own. A dilution of ownership will occur when new shares are issued to investors other than the existing shareholders. With the exception of rights issues, new issues of shares therefore result in a dilution of ownership. If existing shareholders are reluctant to support a rights issue, they might prefer their company to raise new capital by borrowing, so that dilution does not occur.

e) **Maximum loan limits**

When companies borrow from a bank, the lending bank will insist on various covenants being written into the loan agreement. A covenant is an undertaking by the borrower, and breach of a covenant will put the borrower in default. (Similarly, when a company makes a bond issue, there will be covenants.)

A common type of covenant is one that places restrictions on a company's ability to raise new debt capital, or that sets a borrowing limit on the total debt capital the company is permitted to have. If a company has an existing bank loan or bond issue that restricts its total borrowings and it is nearing the permitted borrowing limit, the company might be unable to raise new capital by borrowing, without breaching its covenant. In such a situation, the company would have to consider equity capital as its only funding option (unless it can redeem the loan or bond issue to which the restrictive covenant applies, and so free itself from the restriction).

f) **Interference in decision-making**

Loan covenants given by a borrower might have the effect of restricting the borrower's freedom of action. If a bank insists on excessively harsh covenants, a company might decide against obtaining a bank loan.
g) Security required

With debt finance, the lender often requires security, in the form of a charge over assets of the company. A company might be unable to borrow if it has insufficient assets to offer as security.

h) Persuading investors to provide the capital

When a company wants to raise new capital in the market, by issuing shares or bonds, it has to make the issue attractive. The issue therefore needs to be 'marketable'. Investors will want to know why the capital is required, and what returns are expected from investing it. If the reasons for wanting the capital are unconvincing, investors are unlikely to subscribe to the issue.

i) Conditions in the market

Conditions in the capital markets change over time. The international bond markets go through periods when particular types of bond issue are in demand, and other times when investors are unwilling to buy particular types of bond, or even any bonds at all. For example, the markets for convertible bonds or for sterling-denominated bonds go through periods of strong demand from investors and weak demand. A company might be advised to make a particular type of bond issue to take advantage of a window of opportunity.

In the same way, the demand for new share issues goes through cycles. When share prices are rising and the economic outlook is good, investors are keen to buy shares. When share prices are falling, or when companies in a particular industrial sector are doing badly, raising capital through share issues might be impossible (unless the shares are issued at a very large discount to the current market price, an option that the company is unlikely to take).
Purpose

The choice of financing method will be affected by the purpose for which the capital is required.

Short-term finance, such as factor finance, should be used to finance day-to-day operations ('working capital'). Similarly, a bank overdraft should be used to finance day-to-day operations, and should not be used to acquire long-term assets.

2.1.5 The Capital Asset Pricing Model

The CAPM postulates that the equilibrium return on any risky security is equal to the sum of the risk-free rate of return, the risk premium measured by the product of the market price of risk and the security’s systematic risk (Beta). Mandelker & Rhee (1984) proved that Beta (b) can be expressed as the product of three elements. First is the risk due to the firm’s asset structure, which can be captured as the firm’s degree of operating leverage (DOL). This variable represents the firm’s capital intensity. Second is the firm’s risk due to its financial structure which can be expressed as its degree of financial leverage (DFL). This variable represents the firm’s debt intensity. Finally, the firm’s intrinsic risk which is the uncertainty faced by an all-equity and all-variable cost firm.

Robert (2010), without debt in its capital structure, a company’s asset beta equals its equity beta for projects of equivalent risk. However, according to MM theory of capital structure based on their law of one price and the arbitrage process, companies that are identical in every respect apart from their gearing should also have the same asset betas. Because their business risk is the same, the factors are not influenced by methods of financing.
2.2 Financial Performance

2.2.1 Profitability

Michael, (1992), the concept of profitability is based on the cash outflows required to implement a strategic alternative with the cash inflows that this alternative is expected to generate. The profitability measured includes profitability in relation to sales and the profitability in relation to investment.

2.2.2 Return on Equity

For publicly traded companies, the relationship of earnings to equity or Return on Equity is of prime importance since management must provide a return for the money invested by shareholders. Return on Equity is a measure of how well management has used the capital invested by shareholders. Return on Equity tells us the percent returned for each dollar (or other monetary unit) invested by shareholders. Return on Equity is calculated by dividing Net Income by Average Shareholders’ Equity (including Retained Earnings). Evans, (2000)

2.2.3 Return on Asset

Return on Assets measures the net income returned on each shilling of assets. This ratio measures overall profitability from our investment in assets. Higher rates of return are desirable. Return on Assets is calculated as Net income divided by average total assets.

2.2.4 Debt to Equity

This ratio is obtained by dividing the 'Total Liability or Debt ' of a company by its 'Owners Equity, i.e. Net Worth'. The ratio measures how the company is leveraging its debt against the capital employed by its owners. If the liabilities exceed the net worth then in that case the creditors have more stake than the shareowners.
2.2.5 Liquidity ratios

Liquidity Ratios are ratios that come off the Balance Sheet and hence measure the liquidity of the company as on a particular day i.e. the day that the Balance Sheet was prepared. These ratios are important in measuring the ability of a company to meet both its short term and long term obligations.

2.2.6 Quick ratios

This ratio is obtained by dividing the 'Total Quick Assets' of a company by its 'Total Current Liabilities'. Sometimes a company could be carrying heavy inventory as part of its current assets, which might be obsolete or slow moving. Thus eliminating inventory from current assets and then doing the liquidity test is measured by this ratio. The ratio is regarded as an acid test of liquidity for a company. It expresses the true 'working capital' relationship of its cash, accounts receivables, prepayments and notes receivables available to meet the company's current obligations.

2.2.7 Current ratio

This ratio is obtained by dividing the 'Total Current Assets' of a company by its 'Total Current Liabilities'. The ratio is regarded as a test of liquidity for a company. It expresses the 'working capital' relationship of current assets available to meet the company's current obligations.

2.2.8 Earnings per share

Growth in earnings is often monitored with Earnings per Share (EPS). The EPS expresses the earnings of a company on a "per share" basis. A high EPS in comparison to other competing firms is desirable. The EPS is calculated as;

\[
\text{Earnings available to common holders/ Number of shares outstanding.}
\]
2.3 Empirical Literature Review

Relationship Between Capital Structure and Financial Performance

There are many variables in a capital structure choice and structure of debt maturity which will affect a company’s performance. Debt maturity will influence a company’s option in investing. Furthermore, tax rate will also affect company’s performance. In the case of this, examine the impact of capital structure’s variables base on company’s performance will present prove for a company’s performance due to the effect of capital structure (Tian & Zeitun, 2007). A study had been done by Abor (2005) on the influence of capital structure on profitability of listed companies on the Ghana Stock Exchange during a five-year period. He found out that there is significant positively interrelated between SDA and ROE and shows that firms which earn a lot use more short-term debt to finance their business. In other words, short-term debt is an essential source of financing in favor of Ghanaian companies, by representing 85 percent of total debt financing. Yet, the results showed the adverse relation between LDA and ROE. The regression output showed that there is positive relationship between DA and ROE which measure the relationship between total debt and profitability,. This indicates that firms which earn a lot are depending on debt as their key financing option.

A study done by Gleason, Mathur and Mathur (2000) on relationship between culture, capital structure and performance, using data from retailers in 14 European countries, shows that capital structures differ by the cultural classification of retailers which are strengthen to the inclusion of control variables that will influence capital structure. Furthermore, result also shows that retailer performance is not depending on the cultural influence. Where else, capital structure will influences performance. In the early study on relationship between capital structure and a firm’s reaction to short term financial distress had shown the result that high-leverage firms are more possible than their less-leverages counterparts to react operationally to short-term distress. The high-leverage firms are also more possible to take personal actions such as restructuring assets and
lying off employees when performance deteriorates. Apart from that, a firm with high leverage will react quickly in financial through cutting down dividend, restructuring debt and bankruptcy (Ofek, 1993).

A study (Akintoye, 2008) had been done on sensitivity of performance to capital structure on selected food and Beverage Company in Nigeria. The result shows that performance indicators to turnover (Earnings before Interest and Taxes, Earning per Share and Dividend per Share) and the measures of leverage (Degree of Operating Leverage, Degree of Financial Leverage and Dividend per Share) are significantly sensitive. There are many approaches in examining firm performance. Berger and Bonaccorsi (2006) had used profit efficiency as the performance measure. Manager’s performance were evaluate by using profit efficiency because profit efficiency counter for the effectiveness of manager to raise revenue and control cost and is close to the concept of value maximization. By measuring the profit efficiency, shareholder losses from agency costs are relatively close to the losses of potential accounting profits. The result shows that neither higher leverage nor lower equity capital ratio are connected with higher profit efficiency for all range of data. A research (King & Santor, 2008) had been done to examine the linkage between family ownership, firm performance and capital structure on Canadian firms. Based on Tobin’s q ratios, the result shows that self-supporting family owned firms with a single share class have similar market performance compared to other firms, superior accounting performance based on ROA, and higher financial leverage based on debt-to-total assets. Comparatively, family owned firms which use dual-class shares have valuations that are lower by 17% on average relative to broadly held firms, even though having similar ROA and financial leverage.

Capon et al. (1990), who suggested that out of the 149 relationships, reported using debt as the independent variable and firm performance as the dependent variable, 90 reported a negative relationship. Besides that, a number of studies support this negative relationship, Kester, (1986), Friend and Lang, (1988); Titman and Wessels, (1988);
Harris and Raviv (1990); Shah (1994); Rajan and Zingales, (1995); Wald, (1999); Booth et al., (2001); Fama and French, (2002). However, a number of studies found the relationship is positive, Roden and Lewellen, (1995); Champion, (1999); Gosh et al., (2000); Hadlock and James, (2002); Berger and Bonaccorsi di Patti, (2006). Moreover, Ibrahim El and Sayed Ebaid (2009) point out that capital structure decision has a weak-to-no impact on firm’s performance.

Abor (2005) found that Short-term and Total Debt is positively related with firm's ROE, whereas Long-term Debt is negatively related with firm's ROE. While examining the relationship between capital structure and performance of Jordan firms, Zeitun and Tian (2007) found that debt level is negatively related with performance. In a similar study on microfinance institutions in sub-Saharan Africa, Kyereboah-Coleman (2007) found that high leverage is positively related with performance (i.e. ROA and ROE) and Abor (2007) on small and medium-sized enterprises in Ghana and South Africa showed that long-term and total debt level is negatively related with performance.

A study by Ibrahim El-Sayed Ebaid, (2009) based on a sample of non-financial Egyptian listed firms from 1997 to 2005 reveals that capital structure choice decision, in general terms, has a weak-to-no impact on firm's performance. Results of some studies, such as Myers (2001) and Eldomiaty (2007) show that capital structure is not the only way to explain financial decisions. Probably this explains the contradictory results of the studies that empirically tested the predictions of relationship between leverage and firm's performance. As explained by Jermias (2008), only the direct effect of financial leverage on performance is examined by prior studies however leverage-performance relationship may be affected by some other factors like competitive intensity and business strategy.

Huson Joher, Ali Ahmed and Nazrul Hisyam Ab Razak Sr. (2008) examines the relationship between ownership structure and company performance has been issue of interest among academics, investors and policy makers because of key issue in understanding the effectiveness of alternative governance system in which government ownership serve as a control mechanism. Therefore, this paper examines the impact of
an alternative ownership/control structure of corporate governance on firm performance among government linked companies (GLCs) and Non-GLC in Malaysia. It is believed that government ownership serve as a monitoring device that lead to better company performance after controlling company specific characteristics. We used Tobin's Q as market performance measure while ROA is to determine accounting performance measure. This study is based on a sample of 210 firms over a period from 1995 to 2005 Panel Based regression approach was used to determine the impact of ownership mechanism on firm's performance. Findings appear to suggest that there is a significant impact of government ownership on company performance after controlling for company specific characteristics such as company size, non-duality, leverage and growth. The finding is off significant for investors and policy marker which will serve as a guiding for better investment decision. B.Nimalathasan & Valeriu Brabete (2010) pointed out capital structure and its impact on profitability: a study of listed manufacturing companies in Sri Lanka. The analysis of listed manufacturing companies shows that Dept equity ratio is positively and strongly associated to all profitability ratios (Gross Profit, Operating Profit & Net Profit Ratios)

2.4 The Conceptual Framework

Based on the study, the following conceptual model may be constructed.

Conceptualization model shows the relationship between capital structure and financial performance of CRDB bank Plc, with the capital structure (debt/equity) being the independent variable, whereas financial performance is the dependent variable.
2.5 Hypotheses

Based on the variables, the following hypothesis will be formulated for the study;

$H_0$: There is no impact of capital structure on financial performance.

$H_1$: The capital structure has significant impact on financial performance.

$H_2$: The capital structure has insignificant impact on financial performance.
CHAPTER THREE
RESEARCH METHODOLOGY

3.0 Introduction

Good research methods do not just happen; instead, they are deliberately employed in a way that it designed to maximize the accuracy of the results (Meyer, 2008). This chapter explains research methodology which was used to investigate the main research question “The impact of capital structure on financial performance. Specifically, the chapter describes the research design, sample and sampling (Participants of the study), study area and instruments for data collection as well as data analysis plan.

3.1 Research Design

The research design in this study is the case study which was conducted at CRDB Bank plc in Mwanza city. This design has been chosen because it is flexible to the variety of data collection techniques such as qualitative method and it did help the researcher to save the limited time and fund. Also it facilitated more concentrations in this particular organization and carry out a detailed study of the research.

3.2 Data collection methods

Secondary data was used. Information was gathered by the researcher so as to answer the queries and meet the research problem. On the other hand, primary data was used to a small extent. This was achieved mainly through interviews with selected senior staff members as pertained to the bank’s performance. However the impact of primary data as gathered from interviews and other explanatory variables was held constant as control variables. Only the impact of capital structure was analysed.
3.2.1 Secondary Data

This includes journals, articles, financial statements and all other relevant publications by the CRDB bank. I acquired all of the above named sources of secondary data as published by the bank. However the major concern of the researcher was on the financial statements of the previous fifteen consecutive years, 1998 to 2012 financial statements.

3.3 Data Analysis

From the acquired secondary data, different comparable ratios which are normally used as a basis for performance measurement were calculated. Also the capital structure as measured by the debt-equity ratio was determined for respective financial years, there by correlated with the financial performance so as to find the relationship between capital structure and financial performance. The data was analysed using a computerized data analysis package known as SPSS 16.

3.4 Measurement of the Study Variables

Capital Structure

Capital structure was measured by the debt to equity ratio, which was determined by dividing the total liabilities of the business by the total shareholders’ funds (Pandey, 2005) as indicated below. The business’s total liabilities were limited to third party liabilities regardless of the term of the loan.

\[
\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Shareholders’ funds}}
\]
Financial Performance

This was measured by referring to the profitability ratios, which measure operating efficiency of a company. However, only some of the ratios were calculated. These are as follows.

Net profit margin was obtained by dividing profit after tax by sales/revenue, denoted by;

\[
\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}
\]

Profitability on investment was measured by Return on Equity, denoted by the formulae below;

\[
\text{ROE} = \frac{\text{Profit after tax}}{\text{Equity}}
\]

Return on Asset, which indicates how a company is profitable in relation to its assets was measured by;

\[
\text{ROI} = \frac{\text{Net profit}}{\text{Total assets}}
\]

The earnings per share on the other hand were measured by the formulae below;

\[
\text{EPS} = \frac{\text{Net income} - \text{dividends on preferred stock}}{\text{Weighted average outstanding shares}}
\]
CHAPTER FOUR
PRESENTATION OF THE RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

This chapter outlines findings of the study derived from secondary data. The findings are presented in tables and graphs. The relationship between the variables was ascertained by correlation and linear regression analysis. The findings were interpreted in relation to the research objectives and in consistence with the literature reviewed in chapter two.

4.2 Correlation Analysis

Correlation is concerned about describing the relationship between two variables. In this study correlation coefficient analysis was undertaken to find out the relationship between capital structure and financial performance.

<table>
<thead>
<tr>
<th>Table 4.1</th>
<th>Relation between capital structure and NP margin</th>
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<tbody>
<tr>
<td></td>
<td>DE</td>
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<td>DE</td>
<td>Pearson Correlation</td>
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<td></td>
<td>Sig. (2-tailed)</td>
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<td>NPMargin</td>
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<td>N</td>
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</tbody>
</table>

Table 4.1 shows the relationship between capital structure and net profit margin. There is a weak negative relationship between the two variables. The correlation is -0.095. Significant level is 0.736.
Table 4.2  **Relation between capital structure and ROA**

<table>
<thead>
<tr>
<th></th>
<th>DE</th>
<th>ROA</th>
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<tbody>
<tr>
<td><strong>DE</strong></td>
<td>Pearson Correlation</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
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<td></td>
<td>N</td>
<td>15</td>
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<tr>
<td><strong>ROA</strong></td>
<td>Pearson Correlation</td>
<td>0.021</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
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<td></td>
<td>N</td>
<td>15</td>
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</tbody>
</table>

Table 4.2 illustrates the relationship between capital structure and ROA. There is a weak positive relationship between capital structure and ROA variables. The correlation is 0.021. The significant level is 0.942.

Table 4.3  **Relation between capital structure and ROE**

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<th>DE</th>
<th>ROE</th>
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<tbody>
<tr>
<td><strong>DE</strong></td>
<td>Pearson Correlation</td>
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</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
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<tr>
<td></td>
<td>N</td>
<td>15</td>
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<tr>
<td><strong>ROE</strong></td>
<td>Pearson Correlation</td>
<td>-0.065</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
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<td></td>
<td>N</td>
<td>15</td>
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</tbody>
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Table 4.3 indicates the relationship between capital structure and ROE. There is a weak negative relationship between capital structure and ROE. The correlation is -0.065. Significant level is 0.817.
Table 4.4: Relation between capital structure and EPS

<table>
<thead>
<tr>
<th></th>
<th>DE</th>
<th>EPS</th>
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<tbody>
<tr>
<td>DE</td>
<td>Pearson Correlation</td>
<td>1</td>
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<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
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<tr>
<td></td>
<td>N</td>
<td>15</td>
</tr>
<tr>
<td>EPS</td>
<td>Pearson Correlation</td>
<td>0.524*</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
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<tr>
<td></td>
<td>N</td>
<td>15</td>
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Table 4.4 shows the relationship between capital structure and EPS. There is a slightly positive relationship between the two variables. The correlation is 0.524, the significant level is 0.045.

4.3 Regression Analysis

Regression analysis was used to test the impact of capital structure on financial performance of CRDB bank Plc.

Table 4.5 Regression of capital structure and NP margin

<table>
<thead>
<tr>
<th>Model</th>
<th>Variables Entered</th>
<th>Variables Removed</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>DEa</td>
<td></td>
<td>Enter</td>
</tr>
</tbody>
</table>

a. All requested variables entered.

b. Dependent Variable: NPmargin
Table 4.6: R-values on regression of capital structure and NP margin

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.095a</td>
<td>0.009</td>
<td>-0.067</td>
<td>0.11453</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE

Table 4.6 shows the weak negative correlation between capital structure and NP margin.

Table 4.7: Residuals on regression of capital structure and NP margin

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>0.002</td>
<td>1</td>
<td>0.002</td>
<td>0.119</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>0.171</td>
<td>13</td>
<td>0.013</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0.172</td>
<td>14</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE
b. Dependent Variable: NPmargin

Table 4.8: Coefficients on regression of capital structure and NP margin

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>0.282</td>
<td>0.103</td>
<td>2.735</td>
</tr>
<tr>
<td></td>
<td>DE</td>
<td>-0.003</td>
<td>0.008</td>
<td>-0.345</td>
</tr>
</tbody>
</table>

a. Dependent Variable: NPmargin

Table 4.8 indicates the coefficient of correlation between capital structure and net profit. The multiple R square ($R^2$) is 0.009. This means that only 0.9% of variance of net profit
is accurate by the capital structure. For that case, the remaining 99.1% of variance with net profit is attributable to other factors.

Table 4.9: Regression of capital structure and ROE

<table>
<thead>
<tr>
<th>Model</th>
<th>Variables Entered</th>
<th>Variables Removed</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>DE(^a)</td>
<td></td>
<td>Enter</td>
</tr>
</tbody>
</table>

a. All requested variables entered.

b. Dependent Variable: ROE

Table 4.10: R-values on regression of capital structure and ROE

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.065(^d)</td>
<td>0.004</td>
<td>-0.072</td>
<td>0.11995</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE

Table 4.10 shows the weak negative correlation between capital structure and ROE.

Table 4.11: Residuals on regression of capital structure and ROE

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>0.001</td>
<td>1</td>
<td>0.001</td>
<td>0.056</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>0.187</td>
<td>13</td>
<td>0.014</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0.188</td>
<td>14</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE

b. Dependent Variable: ROE
Table 4.12: Coefficients on regression of capital structure and ROE

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>0.256</td>
<td>0.108</td>
<td>2.374</td>
</tr>
<tr>
<td></td>
<td>DE</td>
<td>-0.002</td>
<td>0.009</td>
<td>-0.065</td>
</tr>
</tbody>
</table>

a. Dependent Variable: ROE

Table 4.12 indicates the correlation coefficient between capital structure and ROE. Multiple R square is 0.004. This means that only 0.4% of variance of ROE is accurate by the capital structure. That is to say, only 0.4% of ROE can be explained by the capital structure. The remaining 99.06% of variance is attributable by other factors.

Table 4.13: Regression of capital structure and ROA

<table>
<thead>
<tr>
<th>Model</th>
<th>Variables Entered/Removed</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>DE</td>
<td>Enter</td>
</tr>
</tbody>
</table>

a. All requested variables entered.

b. Dependent Variable: ROA

Table 4.14: R values on regression of capital structure and ROA

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.021</td>
<td>0.000</td>
<td>-0.076</td>
<td>0.02092</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE

Table 4.14 indicates the weak negative correlation between capital structure and ROA.
Table 4.15: Residuals on regression of capital structure and ROA

ANOVA\textsuperscript{b}

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regression</td>
<td>0.000</td>
<td>1</td>
<td>0.000</td>
<td>0.006</td>
<td>0.942\textsuperscript{a}</td>
</tr>
<tr>
<td>Residual</td>
<td>0.006</td>
<td>13</td>
<td>0.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>0.006</td>
<td>14</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), DE

b. Dependent Variable: ROA

Table 4.16: Coefficients on regression of capital structure and ROA

<table>
<thead>
<tr>
<th>Coefficients\textsuperscript{a}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unstandardized Coefficients</td>
</tr>
<tr>
<td>Model</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>1 (Constant)</td>
</tr>
<tr>
<td>DE</td>
</tr>
</tbody>
</table>

a. Dependent Variable: ROA

Table 4.16 shows the coefficient of correlation between capital structure and ROA. The multiple R square is 0. No percentage of variance of ROA is accurate by the capital structure. 100% of variance with capital structure is attributable to other factors.

Table 4.17: Regression of capital structure and EPS

<table>
<thead>
<tr>
<th>Variables Entered/Removed\textsuperscript{b}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>1</td>
</tr>
</tbody>
</table>

a. All requested variables entered.

b. Dependent Variable: EPS
Table 4.18: R values on regression of capital structure and EPS

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.524(^a)</td>
<td>0.275</td>
<td>0.219</td>
<td>1443.44338</td>
</tr>
</tbody>
</table>

\(^a\) Predictors: (Constant), DE

Table 4.19 shows the weak positive correlation between capital structure and EPS.

Table 4.20: Residuals on regression of capital structure and EPS

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>1.026E7</td>
<td>1</td>
<td>1.026E7</td>
<td>4.924</td>
<td>0.045(^a)</td>
</tr>
<tr>
<td>Residual</td>
<td>2.709E7</td>
<td>13</td>
<td>2083528.803</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>3.735E7</td>
<td>14</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^a\) Predictors: (Constant), DE

\(^b\) Dependent Variable: EPS

Table 4.21: Coefficients on regression of capital structure and EPS

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>-1716.016</td>
<td>1298.245</td>
<td>-1.322</td>
</tr>
<tr>
<td></td>
<td>DE</td>
<td>231.308</td>
<td>104.235</td>
<td>0.524</td>
</tr>
</tbody>
</table>

\(^a\) Dependent Variable: EPS

Table 4.21 shows the correlation coefficient between capital structure and EPS. The multiple R square is 0.275 that means that 27.5% of variance of EPS is accurate by the capital structure. The remaining 72.5% of variance with EPS is attributed to other factors.
Table 4.22 shows the values of range, minimum, maximum, mean and standard deviation of dependent, independent variables. DE has the highest mean value of 11.9307% than other variables. It has maximum value of 18.92 and high variance of 13.697. On the other hand NPmargin has low maximum value and low range value. The maximum and minimum value for each performance indicator indicates that the performance varies substantially from year to year. Capital structure has high mean value compared to the financial performance.

Table 4.22 Descriptive statistics

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Range</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>15</td>
<td>0.07</td>
<td>0.01</td>
<td>0.08</td>
<td>0.0380</td>
<td>0.02016</td>
<td>0.000</td>
</tr>
<tr>
<td>ROE</td>
<td>15</td>
<td>0.38</td>
<td>0.03</td>
<td>0.42</td>
<td>0.2317</td>
<td>0.11583</td>
<td>0.013</td>
</tr>
<tr>
<td>EPS</td>
<td>15</td>
<td>5523.85</td>
<td>17.15</td>
<td>5541.00</td>
<td>1.0436E3</td>
<td>1633.26790</td>
<td>2.668E6</td>
</tr>
<tr>
<td>NPmargin</td>
<td>15</td>
<td>0.35</td>
<td>0.05</td>
<td>0.40</td>
<td>0.2477</td>
<td>0.11087</td>
<td>0.012</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>15</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Figure 4.1 represents the relationship between capital structure and ROA. From the figure it is observable that there is a weak linear positive relationship between the two variables. This is due to the fact that the plots are scattered loosely, hence they would lead to an irregular shaped figure had the line been drawn to connect them.

![Figure 4.1 Capital structure v/s ROA](image)

Figure 4.2 illustrates the relationship between capital structure and ROE. It can be observable that there is a weak linear negative relationship between the two variables. To a great extent the increase in DE ratio leads to a corresponding decrease in ROE. For that case, DE has insignificant impact on ROE.
Figure 4.2  Capital structure v/s ROE

Figure 4.3 illustrates the relationship between capital structure and EPS. It can be observable that there is a slightly positive linear relationship between the two variables. As from the figure, to such a great extent the increase in DE ratio tends to lead to the corresponding increase in EPS. However to some extent this is not the case as it can be observed that when the DE ratio is between 8 and 10, say 9, the EPS value is found to pile up to over 3000. For that case it is safe to say that there is a weak positive relationship between the two variables.
Figure 4.4 represents the relationship between capital structure and NP margin. From the figure it can be observable that there is a weak linear negative relationship between the two variables. This is so due to the fact that to some extent the DE ratio tends to increase with NP margin, to some extent it decreases with the increase in NP margin. Whereas to some point the DE ratio tends to remain nearly constant with far increase in the NP margin. For instance when the DE ratio is approximately 9 on one point in time, the NP margin was nearly 0.01. Then on another point in time when the DE ratio remained nearly the same, the NP margin piled up to approximately 0.20.
4.4 Discussion

The findings from the correlation and regression analysis entail that capital structure has insignificant impact on financial performance, as measured by the selected key financial performance ratios, which are ROA, ROE, EPS and NP margin. This means that only insignificant percentage of the variance in the capital structure is accounted by the financial performance. For instance, in the case of capital structure and NP margin, the study revealed that only 0.9% of variance of NP margin is accurate by the capital structure, with the remaining 99.1% attributed by other factors. The same applied to ROE, where by it is only 0.4% of the variance of ROE that is accurate by the capital structure, meaning that the remaining 99.6% of the variance that is accurate by the capital structure is explained by other factors or variables. This is also the case for ROA, where the study revealed that the variance is extremely 0%. On the other hand it has been observed that about 27.5% of the variance of EPS is accurate by the capital
structure. At least this can be seen as somewhat material, though still insignificant. It is due to the fact that there is a slightly impact of capital structure on EPS. Consider a case when the bank’s capital structure is made of entirely equity. That is to say it is entirely financed by the issue of shares. Then it is obvious that this will have impact on EPS. However it remains clear that only insignificant percentage of the variance of financial performance is accurate by the capital structure. For that case, there are many other factors, being qualitative explanatory variables, and or quantitative factors, that have got major impact on the financial performance, rather than the capital structure. The analysis of this study was based only on the impact of capital structure. As capital structure decisions are not explained much by company’s financial performance, particularly CRDB bank in this study, it is expected that the bank should be having other means of maintaining its financial performance at a steady growth. That is to say, if the bank’s primary objective is to improve its financial performance, it should not rely on capital structure decisions so as to achieve that particular objective.

**Other factors that have significant impact on financial performance**

From the fact that only insignificant variance of the variance of financial performance is accurate by the capital structure, means that the remaining percentage of the variance of financial performance is accurate by other factors. These are as follows;

**General economic conditions**

The general economic conditions tend to have impact on financial performance of firms, CRDB bank in particular. This is where by during recession there are likely to be the decreasing in the degree of direct deposits by the customers. This is due to the fact that during such economic condition, individual customers tend to keep their money with them instead of depositing, as little money is likely to be in circulation. From the fact that direct deposit is one of the bank’s source of profitability (from bank charges), the decrease in direct deposits will have effect on the financial performance. On the
other hand, during boom customers are likely to increase their savings; hence it is advantageous from the perspective of the bank’s financial performance.

**Performance on the equity and capital markets**

Both shareholders and intending investors would always wish to opt for a company whose performance is well on both of the equity and capital markets. Shareholders would wish to continue holding their shares if they can anticipate that such shares will be enjoying a price growth in the near future, otherwise they would be reluctant to keep such shares. Intending investors on the other hand, would wish to invest their funds in the bank that performs well in the equity market. That is a bank that has got many participants in both of the equity and capital markets. For that case it has an effect on the financial performance of the bank.

**Interest rates on borrowing**

In most cases borrowers opt to borrow from the banks that charge low interest rates, so that they cannot repay too much from the principal loan amounts. The CRDB bank charges about 19% to 20% interest on borrowing. It is more likely that an intending borrower may find it sensible to go for a bank that charges below that rate. Hence this will have impact on the financial performance as it leads to decrease in volume of borrowings and hence the decrease in revenue from interest rates. On the other hand if the bank maintains such rate and it is observed that other banks, for instance the Standard Chartered bank which charges about 22% interest on borrowings, then it is likely that CRDB bank will attract intending borrowers who are sensitive to interest rate changes.
**Competitors pricing on services rendered**

This is another factor that affects the financial performance of CRDB bank, rather than its capital structure. Customers are likely to go for the banks that charge low prices on their services. By this I am referring to the bank charges, which is one of the major sources of the bank’s revenue. For instance in the course of withdrawing money through the CRDB automatic teller machines (ATM), a customer is deducted about Tshs 600 on every single withdrawal. Under normal circumstance it is obvious that a customer, who is sensitive to this, might decide to switch to another bank whose charges are lower than this. Hence it affects the bank’s revenue and eventually the profitability.

Subsequently these other factors need so much attention as they play a major role on the financial performance of the bank.

### 4.5 Testing of Hypotheses

<table>
<thead>
<tr>
<th>Capital structure correlated with:</th>
<th>Coefficient of determination</th>
</tr>
</thead>
<tbody>
<tr>
<td>NP margin</td>
<td>-0.095</td>
</tr>
<tr>
<td>ROA</td>
<td>0.021</td>
</tr>
<tr>
<td>ROE</td>
<td>-0.065</td>
</tr>
<tr>
<td>EPS</td>
<td>0.524</td>
</tr>
</tbody>
</table>

Based on the empirical results of this study, the hypothesis $H_1$ “The capital structure has significant impact on financial performance came false, as the study revealed that there is insignificant relationship between capital structure and financial performance as measured by performance measures such as ROA, ROE, NP etc. hence this hypothesis was rejected.

The hypothesis $H_0$ “There is no impact of capital structure on financial performance” also came false. Hence it is rejected as well.
H₂: “The capital structure has insignificant impact on financial performance”. Based on the above gathered evidence, this hypothesis came true, hence it is accepted.
CHAPTER FIVE
SUMMARY, CONCLUSION AND POLICY IMPLICATION

5.1 Introduction

This chapter highlights the discussion, conclusion and recommendations of the findings from the study as presented below. This section is arranged as per research objectives. In order to achieve the research objectives, capital structure (DE Ratio) as well as comparable financial performance ratios were calculated and then each was then correlated with DE so as to find out if DE has the impact on financial performance.

5.2 Conclusion

Correlation analysis shows that there is a weak negative relationship between capital structure and NP margin (-0.095), with significant level of 0.736. This means that NP margin as one of indicators of financial performance can only be influenced by capital structure decision by such a small extent. Also ROE has slightly negative relationship with capital structure. The correlation between the two variables is -0.065 at significant level of 0.817. This implies that capital structure has just a small or minimal influence on ROE. On the other hand, both ROA and EPS have positive relationship with capital structure. The weak positive relationship between capital structure and ROA, (0.021) at significant level of 0.942 implies that ROA can be influenced by capital structure to such a small extent. EPS has a slightly positive relationship with capital structure. The correlation between the two variables is 0.524 at significant level of 0.45, implying that to some extent the capital structure has an impact on the EPS. That is to say the change in capital structure decision can influence EPS.

5.3 Recommendations

In order to increase the financial performance based on capital structure companies should consider taking several measures, such as establishing performance standards. This will enable them to be able to evaluate such performance in such as to be aware of
whether such performance has been achieved by comparing the actual one with that particular standard that was established. Also the bank should consider about the ways of outweighing other factors that affect financial performance, such as inflation. Apart from that the bank should consider lowering of its lending rates and overall interest charged to borrowers so as to attract many more intended borrowers, in order to reduce on non performing loans and improve on the financial performance.

5.4 **Areas of Further Research**

Capital structure does not account for much of the financial performance of CRDB bank as shown by the results of this study. For that case there is a need for further research to find out about the other factors that that affect the financial performance.
BIBLIOGRAPHY


Childs, P.Mauer, D, Ott, S, 2005. Interactions of corporate investment and financing


## APPENDIX

Appendix 1: Key Ratios

<table>
<thead>
<tr>
<th>Key ratios</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>2.6</td>
<td>0.39</td>
<td>0.87</td>
<td>0.82</td>
<td>0.4</td>
<td>1.2</td>
</tr>
<tr>
<td>ROE</td>
<td>25.5</td>
<td>3.2</td>
<td>11.7</td>
<td>13.4</td>
<td>7.2</td>
<td>24.2</td>
</tr>
<tr>
<td>EPS (TSHS)</td>
<td>3400</td>
<td>500</td>
<td>2000</td>
<td>2304</td>
<td>1336</td>
<td>5541</td>
</tr>
<tr>
<td>DPS (TSHS)</td>
<td>1130</td>
<td>0</td>
<td>1100</td>
<td>1000</td>
<td>1000</td>
<td>1200</td>
</tr>
</tbody>
</table>
# BALANCE SHEET AS AT 31ST DECEMBER, 2000

## ASSETS

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash</td>
<td>TZS '000</td>
<td>TZS '000</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>14,025,396</td>
<td>8,870,246</td>
</tr>
<tr>
<td>3</td>
<td>Balances with Bank of Tanzania</td>
<td>16,391,216</td>
<td>13,251,364</td>
</tr>
<tr>
<td>4</td>
<td>Balances with Other Banks</td>
<td>30,406,084</td>
<td>11,993,213</td>
</tr>
<tr>
<td></td>
<td>Investment in Equity</td>
<td>150,000</td>
<td>-</td>
</tr>
<tr>
<td>5</td>
<td>Investments in Debt Securities</td>
<td>68,929,676</td>
<td>47,600,800</td>
</tr>
<tr>
<td>6</td>
<td>Loans, Advances and Overdrafts</td>
<td>34,892,798</td>
<td>34,377,563</td>
</tr>
<tr>
<td></td>
<td>Bills Receivable</td>
<td>578,352</td>
<td>738,310</td>
</tr>
<tr>
<td>7</td>
<td>Accounts Receivable</td>
<td>5,948,578</td>
<td>3,530,072</td>
</tr>
<tr>
<td>8</td>
<td>Fixed Assets</td>
<td>4,044,002</td>
<td>4,406,881</td>
</tr>
<tr>
<td></td>
<td>Leased Premises Refurbishment</td>
<td>304,842</td>
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<td>Cheques and Items for Clearing</td>
<td>14,902,289</td>
<td>5,891,954</td>
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<td></td>
<td>TOTAL ASSETS</td>
<td>190,575,423</td>
<td>130,660,203</td>
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## LIABILITIES

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<tbody>
<tr>
<td>9</td>
<td>Deposits</td>
<td>160,404,207</td>
<td>108,256,526</td>
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<td>10</td>
<td>Due to Other Banks</td>
<td>864,387</td>
<td>1,029,937</td>
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<td>11</td>
<td>Accounts Payable</td>
<td>13,904,796</td>
<td>7,597,198</td>
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<td>Accrued Expenses</td>
<td>242,618</td>
<td>265,255</td>
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<td></td>
<td>Other Liabilities</td>
<td>107,000</td>
<td>25,000</td>
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<td>12</td>
<td>Provision for Taxation</td>
<td>548,262</td>
<td>104,683</td>
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<td>TOTAL LIABILITIES</td>
<td>176,171,270</td>
<td>119,657,299</td>
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<td>TOTAL NET ASSETS</td>
<td>14,404,153</td>
<td>12,502,404</td>
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## SHAREHOLDERS' FUNDS AND RESERVES

<table>
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<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>13</td>
<td>SHARE CAPITAL</td>
<td>8,393,130</td>
<td>8,393,130</td>
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<tr>
<td>14</td>
<td>GENERAL RESERVE</td>
<td>3,554,309</td>
<td>3,554,309</td>
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<tr>
<td>15</td>
<td>SPECIAL RESERVE</td>
<td>13,846</td>
<td>13,846</td>
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<td>16</td>
<td>ACCUMULATED PROFIT/(LOSS)</td>
<td>2,190,046</td>
<td>538,219</td>
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<td>17</td>
<td>LONG TERM LOAN</td>
<td>14,153,231</td>
<td>12,502,404</td>
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<td></td>
<td>TOTAL</td>
<td>14,404,153</td>
<td>12,502,404</td>
</tr>
<tr>
<td></td>
<td>CUSTOMERS LIABILITIES AND INDEMNITIES</td>
<td>2,334,014</td>
<td>513,276</td>
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</tbody>
</table>

## NOTES 1 TO 23 FORM PART OF THESE ACCOUNTS

CHAIRMAN: [Signature]  
DIRECTOR: [Signature]  
MANAGING DIRECTOR: [Signature]

DATE: 11th March 2001
## Balance Sheet

as at 31 December, 2007

<table>
<thead>
<tr>
<th>Note</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tshs'000</td>
<td>Tshs'000</td>
</tr>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and balances with Bank of Tanzania</td>
<td>15</td>
<td>169,410,061</td>
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<tr>
<td>Deposits and balances with other banks</td>
<td>16</td>
<td>189,838,922</td>
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<td>Government securities</td>
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<td>120,427,633</td>
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<td>Other securities</td>
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<td>6,373,469</td>
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<tr>
<td>Available for sale investments</td>
<td>19</td>
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<tr>
<td>Loans and advances</td>
<td>20</td>
<td>3,884,349,820</td>
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<td>Other assets</td>
<td>21</td>
<td>47,483,343</td>
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<tr>
<td>Leased premises refurbishment</td>
<td>22</td>
<td>2,820,634</td>
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<tr>
<td>Intangible assets</td>
<td>23</td>
<td>711,698</td>
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<tr>
<td>Property and equipment</td>
<td>24</td>
<td>14,894,484</td>
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<tr>
<td>Non current assets held for sale</td>
<td>25</td>
<td>3,211</td>
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<tr>
<td>Prepaid operating leases</td>
<td>26</td>
<td>408,146</td>
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<tr>
<td>Taxation recoverable</td>
<td>30</td>
<td>202,072</td>
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<tr>
<td>Deferred tax asset</td>
<td>35</td>
<td>1,748,773</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td></td>
<td><strong>1,142,669,366</strong></td>
</tr>
</tbody>
</table>

| **LIABILITIES** |           |            |
| Customer deposits | 22  | 1,013,331,303  | 791,530,729  |
| Deposits and balances due to other banks | 28  | 1,739,610     | 6,318,250     |
| Other liabilities | 29  | 20,446,641    | 27,307,171    |
| Taxation payable | 30  | 339,253       | -            |
| Subordinated loan capital | 31  | 2,016,000    | 2,616,000     |
| FDICF grants | 32  | 192,368      | 477,243      |
| DANIDA grant | 33  | 141,796      | 1,108,382    |
| RISP grant | 34  | 175,250       | -            |
| **TOTAL LIABILITIES** | | **1,038,640,968** | **828,807,227** |

| **SHAREHOLDERS’ FUNDS** |           |            |
| Share capital | 36  | 24,733,320     | 12,366,668    |
| Reserve reserve | 37  | 79,632,754    | 56,525,684    |
| Statutory reserve | 38  | 262,324      | 513,367      |
| **TOTAL SHAREHOLDERS’ FUNDS** | | **104,628,398** | **69,405,711** |

The financial statements on pages 67 to 105 were approved by the Board of Directors on 14 March 2008 and signed on its behalf by:

Mr. Martin Masani
Chairman

Dr Charles Kamei
Managing Director

Ms. Joyce Luhanga
Director

Mr. Bashoche Mahogi
Director

<table>
<thead>
<tr>
<th>Page</th>
<th>Comment</th>
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</thead>
<tbody>
<tr>
<td>68</td>
<td>Details</td>
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</table>