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DETERMINANTS OF CAPITAL STRUCTURE IN THE KENYA POLICE SACCO

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ABSTRACT

Capital market is the source of long term finance while Money market is the source of short term finance. The motive behind is to minimize the financial costs of funds rising. These financial decisions may be viewed by various capital structure theories: Static Trade Off, Free Cash Flows and Pecking Order theory to assess the influence of liquidity on the Capital Structure of Kenya Police SACCO in Kenya. This study generally sought to assess the influence of liquidity and growth on the Capital Structure of Kenya Police SACCO. The research study incorporated the use of descriptive research design utilizing secondary data which was collected from financial statements between 2013 and 2017. Data was analyzed by the use of descriptive and inferential statistics with the aid of SPSS and thereafter presented in the form of tables. The hypothesis was tested at significance level of 0.05 (95% confidence level). The results revealed that liquidity and growth had significant relationship with capital structure, therefore concluding that liquidity and growth are significant determinants of capital structure of Kenya Police SACCO. This study therefore recommended that SACCOs should aim at onboarding more members, in addition to mobilizing the existing members to increase their share contributions in an effort to build up the level of equity.

Keywords: *Capital Structure, Liquidity, Growth, Kenya Police Sacco*

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INTRODUCTION

In the financing activity, the determination of the best capital structure is the main issue of the company (Lim, 2012). Capital structure refers to a number of options that could be used by a company to obtain the necessary funds for its investment operations in a manner that is compatible with its priorities (Shibru, Kedir, Mekonnen, 2015), this means that the company could raise the funds either by equity or debt or a combination of both. In other words, a company has three alternatives of financing: issuing stocks and bonds, borrowing debts or spending retained earnings instead of distributing them to shareholders as dividends.

The firm's capital structure is considered optimum when the market value of shares is maximized (Pandey, 1990).Gilchrist and Himmelberg(1995), as quoted in Liu and Pang (2009) observed that firms are financially constrained in that they preferred using internal funds that are less expensive than external sources. Kilonzo (2003), as quoted in Mwaka(2006) further argues that a firm that relies too much on debt suffers from high charges of interest rates and this may utilize further returns required for future growth as well as jeopardizing its operations. various theories of capital structure since the introduction of irrelevance theory by Modigliani & Miller in 1958 has a lot to provide thoughts and views the fundamental research capital structure, the problem of main theories is that all of them can still be seen to have not been able to integrate various aspects differing from capital structure into a single universal theory. Until today, especially, most of these theories only tested on a number of factors in a situation of debt and frictions or limited market circumstances. Knowledge about capital structures has mostly been derived from data from developed economies that have many institutional similarities (Booth et al., 2001).The historical attempt to building theory of capital structure began with the presentation of a paper by Modigliani & miller (MM) (1958).

Kenyan SACCO industry is regulated by the SACCO societies Act (2008) administered by Sacco Societies Regulatory Authority(SASRA) Under this Act, all deposit taking business and specified non-deposit taking businesses within Kenya must be licensed with the SACCO societies regulatory Authority in Kenya under the SACCO Societies Act. It is also a requirement under the SACCO Societies Act that the Sacco Societies Regulatory Authority (SASRA) must approve all SACCOs through licensing to carry out deposit taking businesses, regulate and supervise them. Additionally, all SACCOs are allowed to borrow or lend money and enter into contracts. The SACCO societies Act lays down the terms and standards required by Law for the efficient operation of the SACCO Industry.

Kenya Police Sacco was registered on 20th November 1972 and was issued with a registration certificate. The Society has had growth in its membership from a few hundred's currently stands at 40,101. Objectives of the Kenya Police Sacco are to offer the members complimentary savings and credit services and other financial products as may be required by the members from time to time, to ensure safety and soundness of the members funds through a risk management program or appropriate insurance coverage, to ensure the progress of its members by educating them continuously on the proper use of credit, to perform the function and exercise the powers designated for savings and credit co-operative societies under the applicable law for the benefit of the members, to encourage thrift among members by affording them an opportunity for accumulating savings, to create a source of funds at fair and reasonable rate of interest, to provide an opportunity for each of its members to improve their respective economic and social conditions and to provide its members with credit for purposes of providence or production or both.

LITERATURE REVIEW

Modigliani and Miller Theory

Modigliani and Miller, two professors in the 1950s, studied capital-structure theory intensely. From their analysis, they developed the capital-structure irrelevance proposition. Essentially, they hypothesized that in perfect markets, it does not matter what capital structure a company uses to finance its operations. They theorized that the market value of a firm is determined by its earning power and by the risk of its underlying assets, and that its value is independent of the way it chooses to finance its investments or distribute dividends.

The M&M capital-structure irrelevance proposition assumes no taxes and no bankruptcy costs. In this simplified view, the weighted average cost of capital (WACC) should remain constant with changes in the company's capital structure. Since there are no changes or benefits from increases in debt, the capital structure does not influence a company's stock price, and the capital structure is therefore irrelevant to a company's stock price. However, as we have stated, taxes and bankruptcy costs do significantly affect a company's stock price. In additional papers, Modigliani and Miller included both the effect of taxes and bankruptcy costs.

Modigliani and Miller's study (1958) is considered the keystone for the later studies' contribution to present corporate finance generally and for research on capital structure determinants precisely. This theory was known as irrelevance (MM I) theory due to the suggestion of there is no effect on firm's value under any capital structure the firm possesses. Thus, a firm generates its value form assets it maintains not from what capital structure it has even if it is fully financed by debt or fully financed by equity or a mixture of both debt and equity. This theorem has been based on several assumptions of a perfect capital market which deny the existence of transaction costs related to raising a firm's capital, bankruptcy and taxes as well as all required information on market is available for management (Huang & Song, 2006). This theory has emerged after a thought that suggests that a firm can maximize its value and minimize the cost of capital by the best choice of debt to equity ratio for forming its capital structure (Sangeetha&Sivathaasan, 2013). The former theory stated that the decision of choosing such a capital structure is relevant whereas what M&M I theory presented is completely different as mentioned above

Pecking Order Theory (POT)

Pecking order theory has been based on an ideation that completely differentiates than earlier theories on corporate capital structure. This theory is based on the asymmetric information between managers and investors. Managers know more about the true value of the company and the company's riskiness than less informed outside investors which affects the choice between internal and external financing (Myers, 1984). The most complete definition for pecking order theory was given by Myers (1984); Myers &Majluf (1984). companies prefer internal to external financing and also prefer debt to issuance of Equity. A Company prefers first to use its retained earnings in financing investments as a safest funding source before resorting to any other external source (Frank &Goyal 2009). There is a controversial literature on interpreting companies' preference of debt to issuing shares. Frank &Goyal, 2009 emphasize that companies will not resort to issuing stocks, as long as there is a possibility of obtaining debt. This is due to studying both advantages and disadvantages of those sources of finance. The suggested order in financing investments by the theory was justified by the existence of cheap sources, thus companies start from the cheapest to the most expensive sources for choosing finance to reduce potential financial costs and risks (Fama& French, 2001).

Myers &Majluf (1984) presented another interpretation for the pecking order theory from

the context of asymmetric information. Corporate managers and insiders are supposed to be more parties to know about the values, risks and prospects of their firms than investors that represent outside parties. Usually companies will issue shares when the stock price is fair or overvalued. Investors could understand it easily and consequently the stock price will fall after the management announced to issue stock. Therefore, when internal financing is insufficient a company resorts to an external financing and prefers debt to issuing an undervalued stock. The pecking order theory assumes that the companies with high growth opportunities, typically with important needs for funds, would have higher leverage because of the repugnance of the manager to issue stocks. In consequence, the external sources of financing and the least subject to the information asymmetries would be preferable. Within the framework of the trade-off theory, the relationship between the leverage and the performance of the company should be positive. A profitable company will have a preference for the debt because of the deductibility of the interests from the taxable Income.

Myers found that firms tend to follow a 'pecking order' in financing their projects. First they use internal equity, then debt, and only then do they use external equity (Myers,1984). Ross (1977) earlier argued that firms use more debt to overcome information asymmetries and signal better prospects. Myers (2001) however used information asymmetries to argue that managers are unlikely to issue equity because they fear it will signal that the stock price is overvalued. Allen (1993) and Fama and French (1988) like Myers also found that leverage is inversely related to profitability, which supports the pecking order theory view that debt is only issued when there is insufficient retained income to finance investment.

Capital Structure Life Stage Theory

This theory deals with the relationship between organizational life stage and capital structure. Bender and Ward (1993) focused on the trade-off between business risk and financial risk. They conjecture that business risk reduces over the life stages of a firm, allowing financial risk to increase.

Hovakimian, et al (2001) also suggested that 'firms should use relatively more debt to finance assets in place and relatively more equity to finance growth opportunities', and should, therefore, use progressively more debt in their financing mix as they mature. Damodaran (2001) also supported this view by proposing that expanding and high-growth firms would finance themselves primarily with equity, while mature firms would replace equity with debt. Capital structure life stage theory seems to suggest that debt ratios should increase as the firm progresses through the early life stages.

Empirically, however, little work has been done to support or refute this idea. Morgan and Abetti (2004) in their analysis of the venture-capital financing of biotech ventures, argued that high technology ventures are so risky that they can only be financed by venture capital and private equity sources. Their view supports the theory that riskier firms in the infancy and growth life stage should use more equity. According to Frielinghaus et al., (2005), firms in infancy and growth stages have a high business risk and cannot afford financial risk, while firms in prime and stable stages can afford the extra risk that accompanies debt financing. Firms in the declining life stages would experience a growth in business risk and would need to decrease their exposure to debt.

METHODOLOGY

The researcher adopted descriptive research design which involves observing and describing the behavior of a subject without influencing it. The researcher had no control over the variables. The researcher used this research design to find out the

determinants of capital structure of the Kenya Police SACCO in Kenya.

Cooper and Schindler, (2000) described a population as the total collection of elements about which the researcher wishes to make inference. There were 5,000 Saccos in Kenya. However, the study targeted Kenya Police SACCO which has 63,450 members. It is headquartered in Nairobi and it has 5 branches in Nyeri, Mombasa, Meru, Kisii and Eldoret.

The research utilized secondary data collected from Kenya Police SACCO website, SASRA websites and other reports. Dawson (2009) defines secondary research as collecting data using information from studies of ther researchers in an area or subject.

According to Ember and Ember (2009) secondary data is one collected by other people. Audited income statements, statement of financial position and cash flow statements were collected from the SASRA and Kenya Police SACCO websites. This was for five years period from 2013 to 2017.

FINDINGS AND DISCUSSION

Title and authors

The descriptive statistics and empirical findings of the study variables were discussed and also gave a summary of the findings and interpretations with regard to the study objective. The objective of this study was to establish the determinants of Capital Structure on the Kenya police SACCO in regard to the Liquidity and growth of the Kenya police Sacco.

TABLE 1: DESCRIPTIVE STATISTICS

	Minimum	Maximum	Mean	Std. Deviation
Liquidity	.29	.37	.3420	.03271
Growth (%)	4.16	16.65	9.9285	5.03528
Leverage	.21	2.32	1.0791	.87823

From table 1; Liquidity ranged from 0.29 to 0.37 while the mean liquidity was 0.34 which was above 0.15 which was required by SASRA. The total asset ranged from 14768541 to 24024912. The mean total asset was 18408979.60 with a standard deviation of 3726605.502. The growth ranged from 4.16% to 16.65% with an average growth of 9.92%. The standard deviation for the five years was 5.04%. The capital structure herein measured in term of leverage was ranged from 0.21 to 2.32. The mean leverage was 1.0791 with a standard deviation of 0.878. There was increase in equity as compared to debt.

Table 2: ANOVA Results

ANOVA					
Model	Sum of Squares	Df	Mean Square	F	Sig
Regression	.644	4	.161	10.916	0.008
Residual	.339	23	.015		
Total	.983	27			

a. Predictors: (Constant), Growth, Age, Natural_log_of_assets

b. Dependent Variable: Total leverage *Capital* structure) (Debt/ Capital)

The study revealed that the regression model is lower than the residual model which means that the capital structure accounted much of the variability on the total leverage. The significance being below our threshold of 0.05 confirmed that the significance of capital structure to the total

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leverage was high and confirmed by the F test from the table above, the significance level was 0.008 thus showing that the model was a strong one in predicting the outcome, since it is below the threshold of 0.05. Thus we comfortably concluded that the overall model was good fit for the data. We thus concluded that there is a linear relationship with at least one dependent variable and total leverage.

Table 3: Regression Coefficients

Model	Un-standardized Coefficients		Standardized Coefficients		
	B	std. Error	Beta	T	sig.
(Constant)	-.106	.118		-.899	.378
Growth	.106	.061	.033	.269	.044
Liquidity	.118	.012	.123	2.018	.039

a. Dependent variables: Total leverage /capital structure) (debt/capital)

Both determinants had positive effect on the capital structure, for growth (B=.106, p=.044). When other variables in the model are controlled, a unit change in growth would result to significant change in capital structure by 0.106.liquidity had also a unique significant contribution to the model with B=0.118, p=.039 implying that when other variables in the model are controlled, a unit change in liquidity would result to significant change in capital structure by 0.118 in the opposite direction.

SUMMARY

The purpose of the study was to establish the determinants of capital structure of Kenya Police SACCO. Secondary data was collected between 2013 and 2017. Descriptive statistics indicated that there was positive trend in growth with a standard deviation of 3726605, 5.03%. However, liquidity ratio had been decreasing with a standard deviation of 0.03 respectively. Inferential results indicated that 65.5% of variance in total leverage was significantly explained by the capital structure factors; liquidity (P=0.039), and growth (P=0.032) were found to have significant relationship with capital structure.

CONCLUSIONS

Liquidity: From the regression analysis it is evident that there is a significant influence of the liquidity on total leverage. Since Liquidity of the company had a positive relationship with the total Leverage it means that the Sacco's age determines the capital structure of the Kenya police Sacco.

Growth of the Firm

The growth of the Kenya Police Sacco also had a positive relationship with total leverage. Thus the growth of the Sacco was also an eminent determinant of the capital structure.

RECOMMENDATIONS

From the study, it was evident that there was no specific body that regulated the publication and availability of financial information in the Kenyan market. The existing bodies,

Capital Markets Authority, Sacco Societies Regulatory Authority and Kenya Revenue Authority did not regulate how the market operates effectively. There's need for the government through the respective ministries and parastatals to regulate the market asymmetry in order to ensure that many people can make sound investment decisions when investing in the Sacco industry.

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