

# The Effect of Financing Decision on Firm Performance (A Case of Tanzania)

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## Abstract

This paper examines the effect of financing decision on firm performance using secondary data from Dar es Salaam Stock Exchange (DSE) listed firms in Tanzania. The data analysis used different statistical analysis tools including descriptive statistics, correlation analysis, and regression analysis. The essence of this study is due to the fact that, there are no previous studies examining the relationship between (financing decision) choice of the capital structure and the firm performance done in the area under study for non financial firms regardless of Tanzania being the most growing economy at Sub Sahara Africa countries as its annual economic growth is about 7% for concurrently more than 10 years (World Economic Forum, 2017). This study comprises of 29 listed firms in Tanzania for the period covering 2005 to 2018. The study finds that, financing decision has significant effect on firm performance. This is due to the analysis reports that, all tested performance measures are significant positively affected by short term debt ratio while the only return on assets report the significant negative effect with total debt ratio being the measure of financing decision. Further studies have to be done on listed financial firms.

**Keywords:** Financing Decision, Performance, DSE, Tanzania.

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## 1. Introduction

Financing decision is one of the crucial decisions expected from firms' managers in order to attain the objectives of the firm. What leads finance managers in their decisions is the firm goal that enables them to choose which methods and strategies and when to use them so that to end up raising the firms' performance. It is due to this decision that the firms' ability to raise fund can be determined; whether the firm can be financed using only short term debts, the total debts, total equity, or the mix of the debt and equity and for which ratio. It is the decision which will end up having poor performance or the best performance. Though there is no one best way of getting the best mix of debt and equity, many literatures discussed the area like (Modigliani & Miller 1958, 1963; Myers 1984; Tudose, 2012; and Nyabakora, et al., 2018).

Efforts of financing the firm is done by looking the firm capital structure limit as discussed by many theories like Modigliani and Miller (1958); though the application of MM theory has been criticized by many authors due to the factors said to be constant to fail to respond the status. In looking on the good structure while incorporating those factors were seem not responding to the status, Modigliani & Miller (1963), came up with the same theory but incorporating taxation. Other researchers still were trying to look for the solution of the best capital structure and came up with their findings like, Myers (1984), Rajan and Zingales (1995), Tudose (2012), Muhammad et al., (2014), Sagara (2015), and Zhang & Yu (2016). However, capital structure issues still have no solution due to the fact that some authors tried to look for some factors availability of which could distinguish capital structure of one firm from another (Myers 1984, and Barton & Gordon 1988). In their research Junior & Funcal 2013, found that there are insignificant relationship between leverage and strategies used by the firm.

Furthermore, the studies conducted in Malaysia found the conflicting results due to the evidence collected on the effects of capital structure on the firm performance (Salim & Yadav 2012). Their finding shows that, there are many measure of performance which needs to be considered as highlighted in their studies. From that point of view, it seems that the capital structure and performance is still the puzzle which need researchers to go on working for it so that to come up with the results which could be the solution in decision making on how financing decision can affect the firm performance; and this is the essence of this study. The study observes the firms listed in the Tanzania capital market - Dar es Salaam Stock Exchange (DSE), using data of listed non financial firms from 2005

to 2018. Due to the weakness of the capital market in the area under study, 2008 financial crisis was not considered due to the fact that, Tanzania was not directly affected as it had less exposure in international market (Daud et al. 2016).

The study seeks to test the relationship between funding sources which is measured by leverage ratios, specifically the short term leverage ratio, and total leverage ratio(financing decision); and the performance which is measured by return on assets and return on equity.

The essence of this study is due to the fact that, there are no previous studies examining the relationship between financing decision and the firm performance done in the area under study for non financial firms regardless of Tanzania being the most growing economy at Sub Sahara Africa countries as its annual GDP growth is about 7% for concurrently more than 10 years (World Economic Forum, 2017).

The next section of this paper highlights some theoretical and empirical studies discussing on the effects of capital structure or financing decision on the firm performance. Thereafter, explaining the methodology and the model used in this study. Finally, the conclusion from the results was presented.

## 2. Literature Review

Argument on which financial structure leads to the firm good performance is believed to be stimulated by the Modigliani and Miller (1958) findings. Their findings revealed that, financing decision have no impact on firm performance in perfect market perspective. This resulted on many authors' criticism on the results like Myers, 1984; Kovenock and Philips, 1995; Rajan and Zingales, 1995; Tudose, 2012; Kajanathan and Nimalthasan, 2013; Akeem et al., 2014; Younus et al., 2014; Muhammad et al., 2014; Mwangi et al., 2014; Zhang and Yu, 2016) saying that, existence of market distortion like information costs, transaction costs, taxation is against perfect market condition. Modigliani and Miller (1963) found the impact of taxation on performance.

However, a number of studies were done in this area in various developed and developing countries in different periods like ((Masulis, 1983; Myers, 1984; Kjellman and Hansen, 1995; Kovenock and Philips, 1995; Rajan and Zingales, 1995; Majumdar and Chibber, 1999; Vicente-Lorente, 2001; San and Heng, 2011; Tudose, 2012; Salim and Yadav, 2012; Kajanathan and Nimalthasan, 2013; Akeem, et al., 2014; Younus, et al., 2014; Muhammad, et al., 2014; Mwangi, et al., 2014; Sagara, 2015; Ramezanalivaloujerdi, et al., 2015; Zhang and Yu, 2016) for the effect of financing decision on the firm performance.

The structure of the combination of the equity and debt can determine the performance of the firm (Abor 2005) when one fails to optimize the structure, it can lead to poor performance and then if not worked on it and revise, to bankruptcy (Eriotis 2007). One of duties of finance managers is to procure and manage the finance; that means, to procure capital which is not too expensive and not too riskier. It has to be optimal. This can happen when the firm's managers are independent of personal interest which pushes against the owners' interest (Myers, 1984). This means, asymmetric information can lead the managers to issue undervalued shares (Jensen and Meckling (1976). Otherwise, the managers may seek for the use of financial flexibility by using debt financing regardless of the interest rates considerations. So, the two (interest rates and Share price) if not well considered, they may lead to the poor performance of the firm. (Bancel and Mittoo, 2002).

However, the macroeconomic of the country may also influence the choice of the capital structure of the firm due to the fact that, some countries allow the use of debts from non financial companies (ie. Finland), and other countries deny the means (ie. United States of America). So, for the countries which allow the debts from non financial sectors (ie. Finland), the firm can have more debts compared to equity (Kjellman and Hansen 1995). They used the case of Finland and United States of America, whereby Finland firms have huge debt ratios compared to American firms. Theoretically, we can say that, Finnish policies get its capital structure optimality level from the trade-off theory; whereby the United States of America use the Pecking order theory to get its capital structure optimality level. Similarly, Nyabakora, W. et al., (2018) found that, due to the prevailing underdeveloped capital market in Tanzania, most firms use short term debts to raise capital for their business undertakings. These all are the country macroeconomic status that determine the financing decision of the firm; which may have the positive or negative effects on the firm performance.

Moreover, Pandey (2001), and Majumdar and Chhibber (1999) report that, due to the government of India and Malaysia to support the financial institutions, firms get debt financing with tolerant collection approach, whereby the firms which fail to repay the installments, they are less cared. In this case, many Malaysian firms raise capital using short term debt financing; regardless of whether have poor performance or good performance.

However, many studies have been done on the area but there are contradictions between the authors which need to be resolved. Empirical evidence by Abor, (2005), and Sagara, (2015) reported the positive correlation between usages of debt financing over equity financing for the better firms' performance. Apart from them, empirical evidence provided by Akeem, et al., (2014); Mwangi, et al., (2014); Muhammad, et al., (2014); Ramezanalivaloujerdi, et al., (2015) revealed that, debt financing leads to poor firm performance. Not only that, Younus, et al., (2014), and Kajanathan and Nimalthasan, (2013), found no correlation between debt financing and firms' performance. The last view is from Abor, (2005); San and Heng, (2011); Salim and Yadav, (2012);

Tudose, (2012) who suggest that, there is mixed relationship, which is caused by the proxies used in the independent and dependent variables (Financing decision, and performance).

Parallel to the above findings, Abor (2005) using all three proxies of debt ratios, found the positive correlation between capital structure and performance; that means, short term debts are used by the start up businesses and those businesses which need to be expanded. This is said to be true in the countries having undeveloped capital markets Chang et al., (2005). Furthermore, Chang (2005) argue that, different proxies could have different results on performance. Myers (1984), Abor (2005) advice that, firms have to use more debts in their financing for the better performance. According to Abor, more debts could indiscipline managers and come up with optimal decisions (2005).

Contributing their views about whether financing strategies have effect on firm performance, Masulis (1983), and Kjellman & Hansen (1995) denotes that, in order to improve performance, firms have to utilize as much debts in their capital structure as possible. Saying that, firms with ability to serve the debts' installments and interest are profitable firms as their able to keep them out of defaults to payments which could result to bankruptcy. This was supported by Su & Vo (2010) that, financial strategies have significant impact of firm performance; so firms' managers have to use their strategic financial decisions to improve performance.

However, Allen (1991), and Akhtar (2005) reported that, in Australia there was negative correlation between debts and firms' performance which is consistent with pecking order theory. In supporting the idea, Booth et al. (2001) denotes that, firms with high performance utilize less external financing due to the fact that, their retention profit could help them in their needy. This contradicts the trade-off theory which encourages high performer firms to use more debts to benefit from tax relief.

Kajananthan and Nimalthasan (2013) highlighting the matter of proxies in the dependent and independent variables, demonstrates that, capital structure as the proxy for financing decision, and return on assets as the measure of firm performance have insignificant relationship. So, managers need to be careful in using debt in their capital structure. The authors recommend that, whenever firms are in need of fund, it is better to give priority to the internal retained earnings rather than debt. They went far by providing the alternatives that, firms in making financial decision, should use debts as the last decision.

### **3. Variables' Description**

#### **3.1 Dependent Variables**

There are numerous studies that were done in the area of the effect of financing decision on firms' performance. Among others, the following studies used performance as were measured by the accounting ratio indicators, such as return on assets (ROA) and return on equity (ROE)- Katerega, Y. N., et al. (2015) Daud W. M. N. et al.. (2016) Khan, A., et al. (2017). In this study, two performance measures were used: ROA which is calculated by Earnings before interest and tax divide by total assets, and ROE was calculated by taking earnings before interest and tax divide by total equity).

#### **3.2 Independent Variables**

Leverage: this is the proxy for financing decision which is tested against firms' performance. The capital market of area under study (Tanzania) is too weak in such a way that, majority of the firms in Tanzania finance their projects using bank loans which is short term finance (Nyabakora, W. et al., 2018, and Mwambuli, E. 2016b). Due to this reason, to test the capital structure of firms, our study employed only short term debts ratio (STDR) which is measured by taking short term liabilities divide by total assets, and total debts ratio (TDR) measured by total liabilities divide by total assets; as proxies for financing decision. This is due to the fact that, no firm in Tanzania financed its operations by only long term debts. This is consistence with previous literature by Nyabakora, W. et al., (2018) that employed total debt ratio and short term debt ratio as proxies for financial leverage.

#### **3.3 Controlling Variable**

Size of the firm may have impact on firm performance due to the fact that, some firms are trusted due to its size and that for big firms to decide which capital structure to employ, it depends to their willingness. This was proven by the empirical literatures by Akdal, S. (2011), and Nguyen T. C. (2015). However, studies by Paseda, O. (2016) argues that, profitability of the firm depend to its size and experience, and so use internal financing more than external financing. This is the reason why we use firm size as a controlling variable in our study.

### **4. Data and Empirical Modeling**

Our study used secondary data for information gathered from the Dar es Salaam Stock Exchange, and World Bank databases from the year 2005 to 2018. To test variables under study, we collected data from only listed non financial firms from DSE; that have full information published as the requirement for all listed firms must publish their audited financial statements and make them available to Registrar of company (Company Act 212 of 2002). This assures the reliability and validity of data collected. Our study consist only non financial firms knowing that,

financial firms have their leverage regulated by Tanzania central bank. The total listed firms were 29, but our sample consists of only 9 firms with audited financial reports published and so available in range period of 2005 to 2018 concurrently. The sample period is a good representative of the population and sufficient to use, (Kothari 2004, Moser & Kalton 1971).

To link the variables under study, we adopted and modified a model suggested by Wellalage and Locke (2012) as shown in the regression model below to test the relationship between capital structure and firms' performance:

$$ROE_{it} = \beta_{10} + \beta_{11}LEV_{it} + \beta_{13}SIZE_{it} + \beta_{12}ECONOMY_{it} + \epsilon_{it} \dots \text{Modal 1}$$

$$ROA_{it} = \beta_{20} + \beta_{21}LEV_{it} + \beta_{23}SIZE_{it} + \beta_{22}ECONOMY_{it} + \epsilon_{it} \dots \text{Modal 2}$$

**Table 1: Definition of the Modal Key Variables;**

Terms	Definition of Terms
LEV	Leverage of the firm 'i' at time 't', and it is decomposed into two proxies – Total Leverage Ratio and Short Term Leverage Ratio
$\beta_0$	The intercept of the equation
SIZE	This is control variable, and it is proxied by logarithm of total assets
ECONOMY	This Dummy variable; whether it is boom economy or recession economy
ROE	Return on Equity; it is proxied by earnings before interest and tax over total Equity
ROA	Return on Assets; it is proxied by earnings before interest and tax over total assets
t	The time period i.e. t = 1, 2, 3...T
$\bar{\epsilon}$	Error estimation
i	The number of the firms i.e. i = 1, 2, 3...N
$\beta$	The change coefficient for independent variables

## 5. Results and Discussion of Findings

### 5.1 Descriptive statistics

Descriptive statistics is the statistics which express or present data in descriptive manner. In this study descriptive statistics consist of two variables that are independent variables (STDR and TDR) and dependent variables (ROA and ROE) as it is shown in the table below;

**Table 2a: Descriptive Statistics Summary**

Variables	Obs	Mean	Std. Dev.	Min	Max
ROA	112	.2133973	.2294734	-.2105593	1.394923
ROE	112	.8502884	3.570452	-.363599	30.1
TDR	112	.4234134	.2462949	.0107989	1.225149
STDR	112	.2563118	.1729775	.0107989	.9478753
CONTROLLING V	112	7.830191	.6696798	6.632784	8.947544

The leverage statistics (Table 2a) show the average of 42.3% and 25.6% for TDR and STDR respectively which mean that Tanzania firms employ low level of debt to finance their investments. This is due to the weak capital market in the country and the higher bank interest rates. For the year 2005 to 2018 Tanzania firms had the average performance of 21.3% and 85% for ROA and ROE respectively. This means, low performance is reported on how efficiency the firms are, in utilizing the available resources though very low leverage, and having a good use of shareholders' fund; with the average size of 7.8 with minimum of 6.6 and maximum of 8.9 which indicate that firms under study are closely related in terms of size regardless of their sector differences.

### 5.2 Correlation Analysis

Coefficients of correlation are used to determine the level and direction of associations. Their values range from -1 (perfect negative correlation) to +1 (perfect positive correlation). The closer to -1 and 1 is the value, the stronger is the relationship between variables under test. The closer to 0 the coefficients, the lesser the relationship; if the coefficient is 0, means, there is no relationship between the variable under test (Maddala, 2001). Our study results present how financing decision relates to the dependent variables namely ROE, and ROA. The relationship between the dependent variables and independent variables shown in the table 2b below;

**Table 2b: Correlation Results**

	ROA	ROE	STDR	TDR	CONTROLLING
ROA	1.0000				
ROE	0.1225	1.0000			
STDR	-0.2911*	0.4280*	1.0000		
TDR	-0.4834*	0.3035*	0.7391*	1.0000	
CONTROLLING V	0.0054	0.0919	0.1460	0.1198	1.0000
V	0.9550	0.3350	0.1245	0.2083	

The table describes that, all the independent variables (STDR and TDR) have the negative effect on ROA while having positive effect on ROE. Our control variable (SIZE) has positive relation with firms' performance.

### 5.3 Regression Analysis

Regression analysis on the effect of financing decision on firm performance can be seen in table 3(a) and (b) below;

**Table 3(a) Regression Results**

Source	ss	df	MS	Number of obs	=	112
Model	260.952457	3	86.9841522	F (3, 108)	=	8.14
Residual	1154.08992	108	10.6860178	Prob > F	=	0.0001
TOTAL	1415.04237	111	12.7481295	R – squarer	=	0.1844
				Adj R – squared	=	0.1618
				Root MSE	=	3.2689
ROA	Coef.	Std. Err.	t	P>  t	[95% Conf. Interval	
TDR	-.4222791	1.870655	-0.23	0.822	-4.130242	3.285684
STDR	9.186031	2.672993	3.44	0.001	3.887694	14.48437
CONTROLLING	.1623728	.4684111	0.35	0.730	-.7660992	1.090845
CONSTANT	-2.596811	3.648508	-0.71	0.478	-9.828788	4.635165

Table 3(a) tests the relationship between financing decision measured by STDR and TDR and firm performance measured by ROE. The results indicate the prevailing significant positive relationship between ROE and TDR, while ROE shows significant positive relation with STDR. In model 1 the coefficient of STDR is positive and statistically significant at 5 percent which means the increase in STDR causes the increase in ROE. The findings are consistent with the previous empirical studies by Katerega, Y. N., Ngoma, M., Masaba, A. K., Nangoli, S., Waswa, Y., Namiyango, S. (2015) supporting the Trade off theory.

Also the results indicate the significant relationship between the control variable (SIZE) and firm performance.

**Table 3(b): Regression Results**

Source	ss	df	MS	Number of obs	=	112
Model	1.44027624	3	.48009208	F (3, 108)	=	11.77
Residual	4.40476786	108	.040784888	Prob > F	=	0.0000
TOTAL	5.8450441	111	.052658055	R – squarer	=	0.2464
				Adj R – squared	=	0.2255
				Root MSE	=	.20195
ROA	Coef.	Std. Err.	t	P>  t	[95% Conf. Interval	
TDR	-.5522047	.1155674	-4.78	0.000	-.7812794	-.32313
STDR	.1840699	.1651352	1.11	0.267	-.1432566	.5113965
CONTROLLING	.0192391	.028938	0.66	0.508	-.0381211	.0765992
CONSTANT	.2493833	.2254016	1.11	0.271	-.1974019	.6961684

Table 3(b) tests the relationship between financing decision measured by STDR and TDR and firm performance measured by ROA. The results indicate the prevailing significant positive relationship between ROA and STDR, while ROA shows significant negative relation with TDR. In model 2 the coefficient of TDR is negative and statistically significant at 5 percent which means the increase in TDR causes the decrease in ROA which is consistent with the previous empirical studies by Rao, N. V., Al-Yahyaee, K. H. M., & Syed, L. A. M., (2007), Mule, R. K., & Mukras, M. S., (2015), Vätavu, S. (2015), Chinaemerem, O., C., & Anthony, O. (2012), Salim, M., & Yadav, R. (2012); who supports the Pecking order theory. Also the results indicate the significant relationship between the control variable (SIZE) and firm performance.

#### 5.4 Diagnostics Tests

The tests involve Durbin Watson test, and heteroskedasticity test as follows;

**Table 4: Durbin Watson Test**

variable	Durbin Watson test
ROA	0.782
ROE	1.063

One of the assumptions of regression is that the observations are independent. If observations are made over time, it is likely that successive observations are related. Hence the Durbin Watson test was adopted to test the presence of autocorrelation. The study adopted robust standard errors to control for the autocorrelation.

#### **Breusch-Pagan / Cook-Weisberg test for heteroskedasticity**

Ho: Constant Variance

Variables: Fitted Value of ROA

Chi<sup>2</sup> (1) = 14.97

Prob > Chi<sup>2</sup> = 0.0001

The study conducted to test heteroskedasticity using Breusch Pagan / Cook Weisberg test. The findings reveal that the P value is greater than 0.05 therefore the null hypothesis accepted for constant variance. It can be concluded that there is no heteroskedasticity.

#### 6. Conclusion

The study assesses the effects of financing decision on firms' performance of listed non financial firms in Tanzania for the period 2005 to 2018 in different industries. Total debt ratio and short term debt ratio being proxies for financing decision as independent variables, and proxies for firm performance being return on total assets (ROA) and return on equity (ROE) as dependent variables; while firm size being a controlling variable.

Descriptive statistics indicates the effect differences between total debt ratio and short term debt ratio as independent variables to the firms' performance as dependent variables. Also, both proxies for dependent variables report the significance of total debt ratio and short term debt ratio; though the case of low leverage employed by firms under study is due to the use of bank loans characterized by high interest rates while the country capital market is infant market.

However, ROA reports the significant negative relation with TDR, while showing positive relation with STDR. Another dependent variable ROE indicates significant positive relation with both TDR and STDR.

Correlation analysis indicates the significant and negative correlation between ROA as proxy for firm performance, and TDR and STDR as proxies for firm financing decision. However, the analysis reports the significant positive correlation between ROE as dependent variable and measure of performance, and TDR and STDR as the independent variables and measure of financing decision. The analysis shows that firm does not differ much in size as was used as controlling variable. In this case, financing decisions have positive and negative effects on Tanzania firm performance.

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