



World Journal of Entrepreneurship, Management and Sustainable Development

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Article information:

To cite this document:

Sulait Tumwine Richard Akisimire Nixon Kamukama Gad Mutaremwa , (2015), "A borrowing cost model for effective performance of SMEs in Uganda", World Journal of Entrepreneurship, Management and Sustainable Development, Vol. 11 Iss 2 pp. 74 - 89

Permanent link to this document:

<http://dx.doi.org/10.1108/WJEMSD-03-2014-0009>

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A borrowing cost model for effective performance of SMEs in Uganda

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Abstract

Purpose – The purpose of this paper is to develop an effective cost borrowing model of qualitative factors that are relevant to micro and small enterprises (SMEs) better performance.

Design/methodology/approach – A valid research instrument was utilized to conduct a survey on 359 SMEs (131 retail businesses, 125 service businesses, 48 farming businesses and 55 other businesses) and 897 respondents that are representative of 397 SMEs and 1,087 respondents. Correlation and regression analysis were conducted to ascertain the validity of the hypotheses.

Findings – It was established that cost of borrowing elements (interest rate and loan processing costs) are associated with SME performance. Furthermore, cost of borrowing as a whole accounts for 31.1 percent of the variation in performance Uganda's SMEs.

Research limitations/implications – Only a single research methodological approach was employed, future research through interviews could be undertaken to triangulate. Multiple respondents in SMEs (owner, manager and cashier) were studied neglecting others. Furthermore, the study used the cross-sectional approach – a longitudinal approach should be employed to study the trend over years. Finally, cost of borrowing was studied and by the virtual of the results, there are other factors that contribute to SME performance that were not part of this study.

Practical implications – There is need to intensify initiatives to encourage greater understanding and acceptance of cost of borrowing, select appropriate elements that includes interest rate and loan processing costs in order to have affordable source of financing to establish and grow SMEs, provide employment, competitive and contribute to countries GDP.

Originality/value – This is the first paper in Sub-Saharan Africa to test empirically the relationship between cost of borrowing and performance of SMEs in the Ugandan context.

Keywords Performance, SME, Cost of borrowing, Interest rate, Loan processing fee, Membership fee

Paper type Research paper

1. Introduction and motivation

Micro and Small Enterprises (SMEs) dominate the business sector in Sub-Saharan Africa accounting for 60 percent of the total number of enterprises (Nuwagaba, 2012). In Uganda, the business sector has since 1990's to-date gained a commendable 8 percent growth per annum contributing 28 percent to Uganda's GDP and to its growth by 37 percent (Uganda Bureau of Statistics (UBOS), 2013; Nuwagaba, 2012). According to Nkundabanyanga *et al.* (2013), Kakuru (2008), Kazooba Charles (2006), SMEs constitute over 60 percent in low-income countries and account for 41 percent of economic growth in Sub-Saharan African countries for a period between



1998 and 2010 while the industry sector contributes 25 percent, service sector 30 percent and the agriculture sector 17 percent. Therefore, for Sub-Saharan African countries and Uganda in particular to grow, they need to put emphasis on the business sector especially SMEs because in addition to their GDP contribution, they create employment to the skilled, semi-skilled and the unskilled labor, need lower investments and offer a method of ensuring a more equitable distribution of national income leading to economic growth and development (Kakuru, 2008). They also increase on national establishment that enables customers get goods and services easily and at reduced prices because of market competition and competitiveness though the service and manufacturing sectors benefit countries in terms of trade preferences and secondary goods (Kazooba Charles, 2006). Despite the great importance attached to SMEs, they face a challenge of accessing capital to finance their establishment due to the high cost attached when it comes to borrowing. This hampers their emergence and eventual growth (Stiglitz and Weiss, 1981).

The main sources of capital for SMEs is mainly retained earnings, informal savings and loan associations, which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus (Enterprise Uganda, 2012). Access to formal finance by SMEs is difficult because of the high risk of default, poor guarantees, lack of information about their ability to repay loans as well as inadequate financial capabilities (Stiglitz and Weiss, 1981).

Like other developing countries, Uganda's, SMEs operate with limited capital cited in the lack of access to finance as a significant constraint on their operations (Nuwagaba, 2012). This is often associated with financial policies and bank practices that make it hard for banks to cover the high costs and risks involved in lending to small firms. Financial institutions that lend to SMEs have registered high administrative costs in loan processing and monitoring and yet the return is low because of small amounts borrowed as well as high risks and default rate since these business enterprises do not have collateral securities (Kuang, 2008). This has resulted in financial institutions shifting the burden to SMEs by way of increasing interest rates, monitoring costs, membership fee to access finances which has affected their performance. As a result, SMEs find them trapped into vicious cycle of poor financial performance brought about by high production costs because they operate on little capital (Kalyango, 2012; Ortiz-Molina, 2007).

The purpose of this study is to develop an effective cost borrowing model of qualitative factors that are relevant to SMEs better performance. This was necessary because the financial constraints SMEs are facing (low sales, high production costs and limited asset base) emanating from limited capital that has resulted into poor product quality, limited output and market and closure because of competitive pressure. In addition, understanding the nature of the costs SMEs meet in financing their businesses is important to management research since it focusses directly on to the costs ought to be; for better performance (Enterprise Uganda, 2012). Coupled with this, attempts by scholars have focussed on financial intermediation (Kamukama, 2013), supply and demand factors for credit (Kakuru, 2008), cause of business failure (Kazooba Charles, 2006) but none of the studies has provided a suitable cost borrowing model that SMEs and micro finance institutions (MFIs) can adopt to enable their growth and better performance.

The paper is organized into five sections and begins with the brief overview of the research study followed by the theoretical reviewed related literature and hypothesis, methodology, results and discussions, summary and conclusions, and lastly research implications, limitations and suggested areas for further research.

2. Theoretical framework and literature review

Theoretical review

Kauffmann and Schneider (2004) in his study about financing SMEs came up with growth borrowing theory which states that financial institutions are determinants in fostering growth of business enterprises through improved performance in terms of profitability, level of sales and asset acquisition. Borrowing acts as a financial problem solver to enterprises without enough capital by acquiring loans and paying them back at a future date literally from the profits generated. The borrowed funds are invested in productive ventures, which results into profits, part of which are used to pay back the borrowed money and other requirements by the lender.

According to the transaction cost approach enshrined in the theory of financial intermediation (Brealey *et al.*, 1977), numerous markets are characterized by informational differences between borrowers and lenders. Borrowers typically know their collateral, industriousness and moral rectitude better than do lenders; entrepreneurs possess “inside” information about their own projects for which they seek financing. Lenders would benefit from knowing the true characteristics of borrowers, but moral hazard hampers the direct transfer of information between market participants. Borrowers cannot be entirely straightforward about their characteristics, nor entrepreneurs about their projects, because substantial rewards for exaggerating positive qualities and verification of true characteristics of businesses/projects by outside parties is costly or impossible.

By analyzing the above theories, Woller and Schreiner (2006), observed that the interference of lending institutions was negatively skewed because benefits were found to be enjoyed by the lenders than the borrowers which limits the growth of SMEs. This was found to be more applicable to small scale enterprises that access little funds, with shorter repayment period resulting in high costs of borrowing. The uncertain nature of SMEs due to unskilled workers, limited capital, has denied them a strong asset base and face acute competition in accessing capital from commercial banks who offer capital at a lesser cost. This gap of not easily accessing funds from commercial banks has been covered by MFIs, which are profit oriented, offer loans to SMEs by levying several charges that are expensive to SMEs.

3. Literature review

Concept of SMEs and borrowing costs

According to MoFPED (2012) and Najjemba (2004), SMEs are defined based on the number of persons employed, investment in plant and machinery and sales turn over. In Uganda, a common understanding of SMEs is an enterprise employing less than five but with a maximum of 50 employees, with the value of assets, excluding land, building and working capital of less than Ugx.50 million (US\$30,000), and the annual income turnover of between Ugshs.10 million and Ugshs.50 million (US\$6,000-US\$30,000).

According to Mwenda and Muuka (2004), financial institutions charge different costs to borrowers but largely based on market conditions, degree of risks and institution’s objectives. They include: simple interest which is calculated only on the principal amount, or on that portion of the principal amount which remains unpaid; compound interest where the borrower is charged interest on interest unpaid; loan management fee (insurance cost cover, ledger fees) and membership fee. This has led to increase in the cost of acquiring loans by SMEs (Youssoufou, 2007).

According to Prevost *et al.* (2008), the cost of borrowing which eventually determines the rate of interest depends on the cost of funds. A large portion of MFIs' funds are sourced from commercial banks and the cost of these funds is the market interest rate which is always high. In fact, this financial expense when combined with the fees paid on such loans and deposits taken, makes borrowing costly to the SMEs. On the other hand, most SMEs do not acquire loans from commercial banks' because their terms and conditions are hard and cannot be met (Kasekende, 2003). As a result, they resort to borrowing from MFIs that charge higher interest rates between 30 and 42 percent than the Development and Commercial banks who charge between 15 and 22 percent. Based on these comparisons, interest rates charged by MFIs are high and unfavourable to SMEs as they significantly increase the cost of borrowing.

Interest rate charge

According to Koegh (2006), interest is the cost of loan to the borrower and the income to the lender calculated on the basis of real interest rate plus inflation, among other factors of which the lenders cannot ignore. The interest rate that you pay to borrow money is influenced by numerous factors relating to the type of loan that you choose, the length of time over which a loan is to be repaid, the collateral, credit history, and the lender that you select are all important aspects of the interest rate that an SMEs will be charged. In addition, the cost of borrowing depends on the operation expenses, level of profits a lending institution expects, the amount of taxes a lending institution incurs (Nuwagaba, 2012).

Accordingly, increasing interest rates have led SMEs to suffer from constraints that lower their resilience to risk and prevent them from growing and attaining economies of scale and therefore remain among the less profitable sector in the Sub-Saharan Africa (Nuwagaba, 2012; Sander, 2000). In Uganda most SMEs have experienced poor financial performance leading to their closure within six months to one year of operation because much of their capital is borrowed and they cannot afford to pay (World Bank, 2012). This has been attributed to unfavorable credit terms like high interest rate and other fees charged at the source before a borrower accesses money from the MFI that finances their businesses (Ministry of Finance, Planning and Economic Development (MoFPED), 2012). SMEs that persist and invest, their financial performance have remained poor due to little funds available, accompanied by high interest rate that increase the cost of doing business since they do not enjoy economies of scale. As a result, many SMEs have remained using poor technology, producing poor quality products that are not competitive in the market, employ unskilled and unqualified workers which has continuously placed them on a weaker financial position (Okurut and Bategeka, 2006). Because of limited literature on the link between interest rate charged and performance of SMEs, calls for testing the following hypothesis:

H1. Interest rates charged positively influence performance of SMEs.

Membership fee/contingency fee

According to (Kuang, 2008), high transaction costs are associated with disseminating and recovering a large number of small-sized loans, often to clients in geographically dispersed areas with poor infrastructure and security conditions. Based on Wei and Tu (2009), SMEs normally borrow from MFIs which demand that every borrower must pay the membership fee; in addition to other costs as a requirement for accessing the loan,

which according to Kuang (2008), worsens the borrowing appetite of SMEs. This cost is taken as a provision for bad debts. In light of Ortiz-Molina (2007) observation, the provisions for bad debts are often a regulatory requirement for bank-led MFIs. Such costs are always transferred to borrowers in form of high costs of borrowing and yet SMEs access small loans which cannot enable them expand to enjoy economies of scale. Furthermore, Faroque (2007) observe that SMEs operate in uncertain environment with lots of risk, each borrower is insured against death as well as bad debts and collapse of the business; a cost met by the borrowers that eventually increases the cost of borrowing which is never paid back to the borrower after his repayment period. This requirement put SMEs at a dare disadvantage and the studies so far carried out are silent about the link between membership fee and performance of SMEs. The researcher therefore sets the following hypothesis:

H2. Membership/contingency fee positively influences performance of SMEs.

Loan processing costs

Insurance fee. According to Vasiliades (2001), lending institutions have criteria they use while fixing interest rate among which is insurance fee, deducted from the source before the loan is disbursed. This is to cater for the period the borrower fails to fulfill his obligation of paying back the borrowed money due to unclear circumstances. In light of this, Youssoufou (2007) observed that there should be credit insurance that pays some or all of a loan back when certain things happen to the borrower such as unemployment, disability, or death, and to MFIs, such funds are met by the borrowers that end up increasing the cost of borrowing. It, however, remains befitting because whether a borrower pays all principle and the interest; he is not refunded the insurance fee deducted. This worsens the financial situation of SMEs (Wei and Tu, 2009).

According to Westover (2008), the essence of insurance fee is to protect individuals and companies against various financial risks, such as loss of sales if fire in a factory prevented it from carrying out its business for a time and failure of a creditor to pay money he owes to the insured. It is due to such risks involved that MFIs tend to charge insurance fee but risks well knowing that their main customers are SMEs that operate in risky environments that pause a threat to their businesses and therefore threatening loan repayment.

Loan management fees

The business of financial institutions is to manage financial risk emanating from either credit, transactional, liquidity and operational risks. MFI's must invest heavily in the development of a methodology that reduces either risks to the borrowers because they depend largely on the un secured clients deposits for their operations especially as a source of loan fund. MFI's are thus forced to charge a certain fee (management fee) to increase on the cash pull for the next borrower; and act as a commitment that will overcome both credit and liquidity risks.

According to Vasiliades (2001), credit risk is the risk to earnings or capital due to borrowers late or non-payment of loan obligation that may lead to MFI's inability to collect anticipated interest earnings and the initial amount disbursed. The study conducted by Omeka (2007) conclude that the credit gap can be bridged by providing for the loan management charge to the borrowers to cater for peer monitoring and other associated costs. However, this has not yielded any fruit because the portion charged is not adequate to monitor a borrower in addition to increasing the financial problems.

More so, Najjemba (2004) observed that loan management includes management of liquidity risk which is the possibility of a negative effect on the interest of owners, customers and other stakeholders of the financial institutions resulting from inability to meet current cash obligations in a timely and cost-effective manner. However, liquid cash may not pay interest to those clients who will have saved in anticipation of an interest on their saved money in addition to scaring away borrowers. According to Omeka (2007), liquidity risk arises from management's inability to adequately anticipate and plan for changes in funding sources and cash needs. Efficient liquidity management requires maintaining sufficient cash reserves on hand to meet client withdrawals; disburse loans and fund unexpected cash shortages while also investing as many funds as possible to maximize earnings. This can be achieved by MFIs charging a fee and offer shorter payment periods to the borrower. This charge reduces on business profits, are unable to acquire assets and recruit competent workers to foster their growth. With the studies so far carried out, they are silent on the linkage between loan processing and performance in the SME literature. In light of this, the researcher hypothesis as follows:

H3. Loan processing costs positively influences performance of SMEs.

4. Performances of SMEs

According to Westover (2008), performance is taken to be the function of an organization's ability to meet its goals and objectives by exploiting the available resources in an efficient and effective way. In a related case, John (2004) establishes that performance entails the firm's ability to serve and produce what the market requires at a particular time and meeting its objectives at the lowest possible cost with the highest possible benefits. In order to assess performance, managers use actions designed to generate sustainable long-term improvements (Alexander *et al.*, 2008). Campbell (2004) observed that organizational performance measures must focus on what makes, identifies and communicates the drivers of success, support organization learning and provide a basis for assessment and rewards. To Kasekende and Opondo (2003), performance is seen in terms of competitive performance, financial performance, and quality of services, flexibility, resource utilization and innovation.

Furthermore, Kuang (2008) stated that appropriate performance measures are those which enable organizations to direct their actions toward achieving their strategic objectives. Koegh (2006) suggests that performance should be looked at in terms of economy, efficiency and effectiveness. Accordingly, economy is acquiring resources in appropriate quantities and at the least cost while efficiency is maximizing inputs for a required output or the extent to which the defined task has been accomplished and is consistent with notions of non-financial accountability and measured in terms of quality of service, customer satisfaction and achievement of goals. Based on the prevailing literature, performance of SMEs will be measured based on liquidity, sales level and asset base.

Liquidity as a measure of organizational performance

According to Maes *et al.* (2000) liquidity relates to the settlement of short-term debts arising from the day to day operations. In the case of SMEs struggling to survive, liquidity is a very important indicator of the state of financial health. As William puts it, liquidity is the degree to which debt obligations coming due to next 12 months can be paid from cash or assets that will be turned into cash. Teszler (1993) concurred with

Okurut and Bategeka (2006) that a firm's liquidity is a good indicator of good financial performance. Ferreira and Vilela (2004) established that the growth opportunities in SMEs is highly attributable to its liquidity and is thus an important factor that positively affects cash levels. Therefore, SMEs with more growth opportunities may incur greater costs of financial distress because their value depends on their liquidity rather than tangible assets or specific cash flows.

However, Kappel and Steiner (2004) concluded that SMEs size is significant in determining liquidity levels. The traditional models to determine the optimal liquidity demonstrate that there are economies of scale associated with the cash levels required to confront the normal transactions of the SMEs, so that as they grow, they can keep lower cash holdings.

Level of sales as a measure of performance

According to Johnson and Tian (2000) and Kasekende and Opondo (2003) sales volume is considered a good measure for performance of SMEs; when sales increase, turnover is bound to increase. This implies that the business is expanding its level of output, an indicator of better performance. Thus, if sales volume is increasing, the productive capacity of the business expands and it eventually enjoy economies of scale that enables it to produce at reduced costs, sell its products cheaply and becomes competitive in the industry. According to Bagozzi (1999), a business is said to be performing better if its sales volume is increasing and in situation where there is efficient business management, sales volume and revenues are bound to increase which enables its liquidity thereby reducing on the business capacity to borrow in order to meet its debt obligations. In contrast to Bagozzi's conclusion, as a business grows, its appetite to borrowing increases.

Asset base as a measure of performance

One of the successes of any business venture is the level of assets it accumulates over time and according to Johnson and Tian, the expansion of a business is measured in terms of the rate at which its assets are growing and being used, leading to enjoyment of economies of scale and hence being competitive in the market. Campbell (2004) in his study confirmed Johnson and Tian's observation that it is the increase in the assets that indicates effectiveness and efficiency of a business's performance. He further noted that a business with strong assets is capable of accessing loans from financial institutions cheaply since such assets can act as collateral security. However, William found a weak correlation between borrowing and increase in asset base by SMEs. For example, young businesses access very little funds from the financial institutions at very high cost yet the returns to these enterprises are low and thus not able to increase their investment to increase on the asset base. However, William's criticism did not provide the direction of that relationship on whether they should borrow or stop borrowing and if they stopped, what would their source of financing. This study therefore will explore this to find out the direction of relationship.

Cost of borrowing and performance of SMEs

Entrepreneurs and small business owners often turn to loans in order to establish or expand their business ventures. Business enterprises that choose this method of funding (debt financing) need to be aware of all components of loan agreements, including the interest, loan processing cost and membership fee. Studies by MoFPED (2012) and Kappel and Steiner (2004) have linked the cost of borrowing

to performance. They assert that the cost of borrowing which is a component of operating expenses, profit motive and inflation rate significantly affects the performance of SMEs. This is measured in terms of output, level of revenue and employment depending on how the borrowed money is put to use.

According to Kappel and Steiner (2004), the cost of borrowing is not a problem as long as the borrowed money is invested in ventures with high rate of return, but for this to be achieved; enough capital should be accessed by the borrowers to increase on their levels of investment so as to enjoy economies of scale. Their findings were in agreement with who found out that loan performance is influenced by the loan size and loan repayment period.

According to MoFPED (2012) a high interest rate regime with shorter loan repayment period undermines the financial performance of SMEs through increased probability of default and non-performing assets that affect liquidity. It further threatens the financial long-term solvency of private sector businesses and especially of local origin, mainly SMEs. Moreover as a result of compounding, a continually rising interest rate increases loan repayment obligation over time and constrains SME operations. The high cost of credit and the small loans available not only affect private sector business through increased costs of operation, but also affect productivity with its associated effect on liquidity and profitability of the enterprises (Wright, 2000).

However, much as the cost of borrowing induces commitment to the productive use of the loan so as to repay, it in turn leads to improved financial performance of the organizations. In support of this, empirical literature, Youssoufou (2007) revealed that subsidized credit in Burkina Faso cooperative banks constantly encouraged borrowers to engage in high productive activities which in turn led to relative financial performance of their businesses. In addition, Koch and MacDonald (2000) provides that the financial stability of Belgian banking sector as well as principles of management and supervision of interest rate risk greatly contribute to the survival of many financial institutions and SMEs. Similar explanation in Bank of International Settlement (2004) as published by Basel Committee on bank supervision provides that interest rate management is critical to the survival of most financial institutions. Following the reviewed literature we hypothesize as follows:

H4. Cost of borrowing positively influences performance of SMEs.

5. Methodology

Design, population and sample

The study used a cross-sectional, qualitative and quantitative research designs to address the stated hypotheses. The study population included 48,897 registered SMEs in Uganda (UBOS, 2013). The sample size of 397 SMEs with 1,087 respondents was generated using Yamane (1973). According to Yamane (1973), the sampling tables indicate that with this range and at precision levels of ± 5 percent (confidence level of 95 percent, $p = 5$), the average sample becomes 397 objects, at precision level of ± 3 percent (confidence level 97 percent, $p = 3$) the sample becomes 1,087 objects and at ± 7 percent (confidence level 93 percent, $p = 7$) it becomes 204 objects. We took the first and second level of 397 SMEs at precision level ± 5 percent and 1,087 respondents (owners and employees) at precision level of ± 3 percent which was representative enough for such population and it fairly yields better results. Besides, the sample size generated using this approach fairly mirrors the results one would have got using a table of random samples by Krejcie and Morgan (1970). Stratified and purposive

sampling techniques were used based on a business that was in existence for the last two years and employs between five and 50 employees and whose capital base is between US\$10,000 and US\$30,000.

The unit of analysis was SMEs and owners and employees acted as units of inquiry. The developed SMEs strata included 144 retail businesses, 142 service businesses, 53 farming businesses and 58 businesses were grouped as others. Out of the employees and owners targeted per SME, three respondents (owner, manager and cashier) were studied. The decision to accept a minimum of three respondents per business was based on previous scholars such as Baer and Frese (2003) and Ngoma (2009).

By opting for this methodological approach, perfect information symmetry is ensured as such respondents are perceived to know how the business operate, is financed and the performance of the business. Such symmetry of information could not be as easily achieved by collecting data from other stakeholders such as the public and other lower workers for instance shop attendants, store keepers because they were presumed to have little information regarding the subject matter.

The study variables were operationalized based on previous studies. In addition, a five-point Likert scale developed by Rensis (1930) was adopted for all item scales ranging from 1 – strongly disagree to 5 – strongly agree. Cost of borrowing was divided into three: interest rate, membership fee and Loan processing costs. Each division was measured basing on the works of other scholars and modified to match the Ugandan study context.

The questionnaire was validated through expert interviews and by a panel of expert practitioners and was then physically delivered to the selected respondents at their work premises on appointment. A survey was adopted as the most appropriate method of data collection and previous research supports the reliability and validity of the self-report measures (Lechner *et al.*, 2006). This approach consists of a selection of key information providers by virtue of their position, knowledge and information available (McEvily and Marcus, 2005).

6. Results and discussion

Sample characterization

Data from 359 SMEs (897 respondents) out of the targeted 397 (1,087 respondents) was received representing an average response rate of 91 percent (131 retail businesses, 125 service businesses, 48 farming businesses and 55 other businesses). The larger number of the respondents were males (512) representing 57 percent and females (385) representing 43 percent; 36 percent (319 respondents) had a bachelor's degree as the highest qualification, 41 percent (371 respondents) had a diploma, 12 percent (111 respondents) had a certificate and the rest 11 percent (96 respondents) had no formal qualification. The majority the businesses, 67 percent (241 businesses) had been in operation for a period of more than five years while the rest 33 percent (118 businesses) had been in operation for a period less than five years. The main source of financing for SMEs; 40 percent were borrowing from MFIs, 28 percent were personal savings, 19 percent from friends and 13 percent borrow from commercial banks. The mean score of the element of cost of borrowing (interest rate, membership fee and loan processing costs) and performance were established as 4.2, 3.9, 3.8 and 4.1 and the standard deviation of 0.56, 0.67, 0.74 and 0.76, respectively, and the CVI were established as 0.87, for the cost of borrowing and 0.77 for performance. Given that the standard deviations are small compared to mean values, it is true that the computed

means highly represent the observed data. In effect, the calculated averages are a good replica of reality (Field, 2006; Saunders *et al.*, 2007).

Additionally, descriptive statistics were performed to assess whether borrowing terms provided by lending institutions to SMEs were favorable. The results showed that majority of the SMEs do not afford the rates of interest as borrowing costs when applying for the loans from financial institutions/SACCO's (Mean = 1.43, SD = 0.605), membership fees is not promptly paid (Mean = 2.32, SD = 0.940), many continue to borrow from financial institutions even when the cost of borrowing is unfavorable to them (Mean = 2.23, SD = 0.714) because they do not have any other source of finance.

7. Correlation results

Principal component analysis was used to extract the factors that measured cost of borrowing provided by lending institutions whose results are; interest rate 15.7 percent, membership fees 17.7 percent and loan processing cost 18.4 percent, explaining 51.8 percent of the borrowing costs while the measurement of performance yielded three factors interpreted as profitability 32.1 percent, liquidity 25.6 percent and asset base 14.5 percent explaining 72.2 percent of SMEs performance.

The findings in Table I, reveal a significant and positive correlation between interest rate charge and performance ($r = 0.434$, $**p < 0.01$; significant at 0.000) supporting of *H1*. In view of interest rate charged, results indicate that levying interest rate on borrowing is a source of capital for MFI's and at the same time a source of value to the performance of SMEs. This is because after making an investment by the owners, they need to manage other operating costs that would take away the available little gross profit, for example, cost human capital and marketing among others. In addition, managers have to work hard, be mindful of what they produce, whom they produce for; all in line of increasing turnover. This stimulates growth and a return to the shareholders. This finding is supported by the transaction cost theory (Brealey *et al.*, 1977), which posits that borrowers know why they borrow and where they are going to invest the money than the lenders do. In addition, Kappel and Steiner (2004) observe that interest charged is not a problem as long as the borrowed funds are invested in ventures with high rate of return. This view point is consistent with Nuwagaba (2012), who argued that SMEs that can minimize on operating expenses than interest charge, employ better methods of business management, borrowing would not be a problem.

In addition, results for testing *H2* revealed a positive but with no significant relationship between membership fee and performance ($r = 0.211$; significant at 0.058). Arising from this study result, it is clear that membership fee is not an important factor in influencing performance of SMEs thus rejecting *H2*. This implies that a positive change in membership charged to the borrower does not improve performance of SMEs. In this case, routine requirement of every new borrower to buy shares in a MFI

	Cost of borrowing indicators	Correlation with export intensity	Comment
<i>H1</i>	Interest rate charged	0.434 (0.000)**	Supported
<i>H2</i>	Membership fee	0.211 (0.058)**	Not supported
<i>H3</i>	Loan processing fee	0.359 (0.001)**	Supported
<i>H4</i>	Cost of borrowing	0.440 (0.000)**	Supported

Note: *,**Significant levels at $p < 0.05$ (95 percent) and $p < 0.01$ (99 percent), respectively

Table I.
Correlations results

to be a member and then borrow, discourages SMEs from accessing loan able funds which is a source of underperformance of Uganda's SMEs because of limited capital. This is an industry where borrowers (SMEs) endure all conditions in order to access finances especially if they are in desperate need for money, they agree for the deduction to cover membership fee which later affects their return on capital employed. However, this finding contradicts the conclusions of Ortiz-Molina who found out that positive and significant relationship exists between membership fee and performance of SMEs. The divergent result in this study could be attributable to the nature of the clients and the businesses they undertake especially in Uganda's environment. For example, in this era of economic hardship and competition, majority of the borrowers in Uganda are to see what they exactly get in relation to what they applied for, because at application, they had ascertained how much they need and what for. Thus, deducting ones money from the source to cover membership fee means that the borrower will not have enough to do what the business want according to the business plan, this may result in multiple borrowing or diversion of funds. In this case, SMEs need not to be charged membership fee if they are to be better served by MFI's; instead, the performance of SMEs will be influenced by the amount of money applied for in full. Nevertheless, SMEs dealing in agriculture (Nuwagaba, 2012) membership fee is paramount because they access the loans at lesser charges in addition to huge loan amount they take, they therefore should contribute to their existence and that of MFI's from whom they borrow.

The result of testing *H3*, indicate a positive and significant correlation between loan processing costs and performance ($r=0.359$, $**p < 0.01$; significant at 0.001). The result indicate that loan processing fee is an important factor in influencing performance of SMEs. This implies that a charge to the borrower to process the loan leads to faster access of requested funds leading to earlier capital investment, hence improved performance of an SME. This finding is in agreement with observations made by Omeka (2007), who established that processing costs such as insurance provide a cover to the borrower in case of default especially in difficult situations where the business is unable to pay back the borrowed money. Also, a study by Youssoufou (2007) in Burkinafaso concluded that processing costs motivate managers and owners of SMEs to work extra harder in abide to recover that cost which the efforts and resources into ventures that create value and sustainable performance. Therefore, the findings of this study affirm that loan processing cost in necessary for the best performance of SMEs and this supports *H3*.

The result of testing *H4* indicate a significant and positive correlation between cost of borrowing performance of SMEs ($r=0.440$, $**p < 0.01$; significant at 0.000). This result means that favorable borrowing costs (interest rate and loan processing costs) now and tomorrow are a source of performance that compels management of SMEs to work extra to pay the borrowed money amidst the mark up. In the Ugandan perspective, people work hard when there is an obligation to discharge, therefore because there is a cost inflicted on the capital borrowed which must be paid, it forces management to work to pay it back (initial capital and other costs of borrowing) and at the same time retain something to justify their stay in business. This justification amounts to improved financial performance (profitability, liquidity and asset base).

Regression results

Regression results in Table II show that cost of borrowing contributes 31.1 percent of the variance in performance of SMEs. This indicates that the three borrowing cost

Model		Coefficients ^a		Standardized coefficients β	<i>t</i>	Sig.
		Unstandardized coefficients <i>B</i>	SE			
1	(Constant)	1.537	0.529		2.790	0.000
	Cost of borrowing	0.357**	0.153	0.357**	7.219	0.000
	$R^2 = 0.251$					
	Adjusted $R^2 = 0.311$					
	<i>F</i> -statistic = 16.412					
	Sig. = 0.000					

Table II.
Regression results

Notes: ^aDependent variable: SMEs performance. **, **Correlation is significant at the 0.05, 0.01, respectively

elements studied account for 31.1 percent of the charges to the SMEs signifying that the remaining 68.9 percent is explained by factors not addressed in this study. In a related manner, cost of borrowing elements has different weights to performance. This finding is consistent with observations of Nuwagaba (2012), Koch and MacDonald (2000) and Youssoufou (2007) who established that the importance of the borrowing cost elements to SMEs performance is always diverse and the disproportion in the contribution of individual borrowing cost elements to performance is influenced by the business industry.

Summary and conclusion

Emanating from the foregoing discuss, the study confirms that, with exception of membership fee, the rest of the borrowing cost elements (interest rate and loan processing fee) are significant predictors of performance in the SMEs of Uganda. Of the three borrowing cost elements, interest rate charge has the highest correlation and therefore is more important in influencing performance of SMEs. A combination of all borrowing cost elements predicts 31.1 percent of the variation in performance of SMEs.

Implications for management and researchers

Managerial implications. The study has introduced a comprehensive understanding of the effect of cost of borrowing on performance of SMEs. This promotes management effort of both SMEs and MFIs to improve on their performance that can be facilitated through the necessary reduction in the interest rate and loan processing costs in a more economical and efficient way taking into account the inflationary pressure. The management on either side (SMEs and MFIs) need to encourage greater understanding and acceptance of the cost of borrowing mix that results in the creation of improved performance, promote economic growth and provide employment in developing countries.

Since SMEs are meeting a number of costs when accessing the loans that are becoming prohibitive and making the operation costs high and eventually affecting their performance, financial institutions should devise a mechanism that can enable them cut the cost of their operation with the intention of cutting down the cost of giving out loans. This will attract more borrowers who are capable of utilizing the borrowed money, make profits and be able to pay back. In this way, both the SMEs and financial institutions will achieve their objectives of better performance.

Since borrowing makes SMEs remain liquid due to continuous borrowing, they should avoid having excess liquidity at hand. The excess quick assets should be invested in more profitable ventures. This will eventually enable them build asset base and reduce their financial dependency from financial institutions for funds.

Theoretical implications

The study has addressed practical issues that have not been attended to for long by both literature and by practitioners and has further shown that cost of borrowing is essential for the survival and performance of SMEs in addition to the employment they provide, improvement in GDP among others. Thus, the study has contributed to the on-going debate concerning the cost of capital in the field of sources of business finance and performance.

From the literature, scholars have different views concerning cost of borrowing and business management dimensions. This study has brought out the key cost of borrowing elements (interest rate and loan processing cost) as crucial elements if an SME is to borrow to attain performance. This therefore widens the literature on cost of borrowing.

Limitations of the study

The findings of this study have some limitations that provide the initiatives for future research; and some of these include:

- Due to the confidentiality of the required information, the data provided were based on business owners, manager and cashier who self-reported on their own SMEs. Therefore, the measures were not based on raw data.
- A single research methodological approach of data collection was used (structured questionnaire). This limited respondents' scope of answering since their views were predetermined.
- Third, a multiple regression for cost of borrowing elements was done producing a single percent for all the studied components. In addition the result (31.1 percent) for cost of borrowing is relatively low an implication that there are other components that contribute to performance that needs a further study.
- Finally, the present study is cross-sectional; it is possible that the views held by individuals may change over the years.

In spite of the limitations, policy makers dealing with service provision, academicians, politicians, heads of MFIs, SMEs and general public interested in the field of cost of borrowing might find this study important.

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