

Lending Terms and Financial Performance Of Small Medium Enterprises In Uganda: Case of Soroti District

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Abstract

The rate of improvement on SMEs performance in developing countries was significantly lower than in the developed world as a result of weak clients' financial performance linked to high lending terms. A cross sectional survey and descriptive research design was used and questionnaire administered to the SMEs. Findings reveal that there was insufficient liquidity, effective financial efficiency of resource utilization, high risk of solvency leading to financial distress and that lending terms of financial institutions are linearly related to the financial performance of SMEs with the lending terms explaining 26.6% variations of the performance of SMEs that borrowed. Thus lending terms of financial institutions had a low influence in performance than other factors.

Keywords: Lending terms, Financial Performance, SMEs, Financial institutions.

1. Introduction

Small Medium Enterprises (SMEs) are the main driving forces of economic growth & job creation that have a special importance, not only in developed countries but also in developing and emerging economies (Cabbar, 2000). SMEs in most countries have barriers to access to finance, difficulties in exploiting the technology, insufficient managerial capabilities, low productivity and regulatory burdens in their business environment. Some SMEs face certain constraints that are less applicable to large companies in Uganda especially 28% of loan defaults, dependent on business development services for growing their businesses, face major constraints in their access to finance and export markets, and are disproportionately affected by regulatory barriers (AMFIU Report, 2008).

Indeed, Goldberg and White (1999) study reveals that MFIs across developing countries affects small business lending positively in urban markets and negatively in rural markets. This kind of borrowing is necessary for business performance and improving SMEs development if it is fully accessible and reasonably fair cost of money. SMEs are some of the businesses in the world that cannot function/survive without an appropriate finance because of the nature of their operations and management style (Kasekende & Opondo, 2003). Most SMEs in Uganda have had access to financial resources from financial institutions; however, they end up in the poor financial state and leading to business collapse before its first anniversary due to lack of entrepreneurial skills, lack of adequate technical and management support services (GEM report, 2008). Also, the cost of money on micro credits is very high, due to the large administrative costs in relations to their location of operations (Sacerdoti, 2007). Lending to SMEs entails higher administration and transaction cost owing to inadequacy of records and information relating to their operations. Some SMEs had difficulties in raising short-term funds for working capital as well as long-term funds for business investment. Enterprises can take in trade credits in addition to institution loans in short-term finances which later hinder their performance in the short period (Ebong, 2007). In order to achieve this role, the SMEs need a good state of financial health and enable them to play economic role through access to financial services from the financial institutions.

Therefore, this makes it difficult for them to achieve their performance in term of liquidity, long term solvency and profitability hence leading to lost business opportunities, and failure to grow in terms of size and financial resources (Badagawa, 2008). This has been linked to high lending terms by financial institutions of between 30% and 36% per annum (MFPED, 2009). According to Wanja (2009), Access to credit facilities is the main constraint for SMEs in Uganda and limited access to capital to meet their operating working capital and long term investments. Lending rates for short and medium term loans range between 17-28% per annum (Mugisha and Kibirige, 2009). The CGAP assessment report (2008) also revealed that Ugandan MFIs clients still existed in the loan cycle and others had dropped out due to poor business performance and difficulty in loan recovery. In line with (IMF report, 2006) and Boehlje *et al* (1999) citing poor performance which is being contributed by low profitability, high cost of borrowings, small loan size and short period of lending to the clients. The development of SMEs would lead to poverty eradication, job creation and increased income levels in relations to achieving MDGs (MFPED, 2008).

2.0 The Small Medium Enterprise Sector in Uganda

SMEs are the backbone of the Ugandan economy, providing a prime source of new jobs, playing a crucial role in income generation, reducing poverty by helping boost employment in rural areas and recognized as an engine of economic growth and development (BIDS report, 2008). Uganda has an extensive small and medium enterprise sector with an estimated number of 1,069,848 SMEs in urban and rural areas which account for 90% of the private sector. They contribute 75% of Uganda's GDP and employ some 2.5 million people (Badagawa, 2007). The SME sector in Uganda, like other developing economies, is highly diversified by ownership, type of enterprise and stage of development (Bid report, 2008). Uganda Small Scale Industries Association reported that SMEs are spread across all sub-sectors of the economy with the majority operating in the informal sector and mainly operated by women especially in food processing, textiles and clothing, manufacturing and handicrafts. The SMEs sector offers a range of investment possibilities, covering all sectors from resource-based industries to manufacturing and services. SMEs occupy a highly useful niche in industrial structure, sub-contracting with large firms engaging in small batch production, made-to-order work, or finishing operations complimentary to large scale industry (BIDS Report, 2008)

2.1 Research Hypothesis

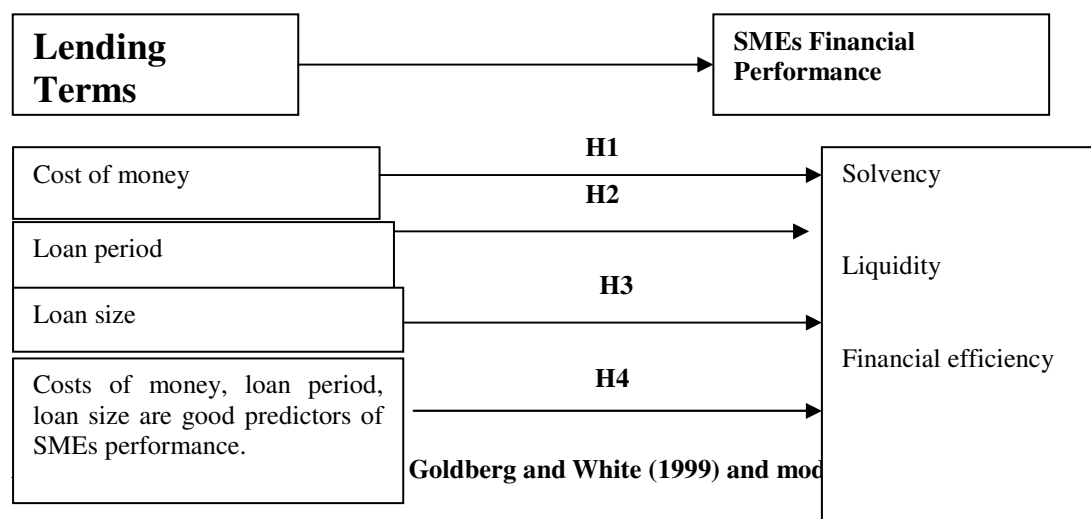
Focusing on financial institutions lending terms and SMEs financial performance in Uganda, the study investigates the following research hypothesis:

- H1: There is an inverse relationship between cost of money and SME performance.
- H2: There is a positive relationship between loan period and SME performance
- H3: There is a relationship between loan size and SME performance
- H4: Cost of money, loan period and loan size are good predictors of SMEs performance.

2.2 Conceptual Framework

The conceptual framework of lending terms and performance of SMEs was well established, drawing largely on the contributions by Goldberg and White (1999) and Boehlje *et al* (1999). Lending terms entails cost of money, loan period and loan size. The Lending terms of financial institutions loans was favorable to SMEs performance in order to reduce payment obligations and commitment to clear the loan in time to avoid default rate and fit the borrower's ability to pay. These were to enhance the SMEs asset accumulation and improve the performance in form of financial efficiency, liquidity and solvency. Loans that match the cash flow ability and favorable cost of money can lead to good repayment ability and capacity. These were to improve the SMEs financial state of performance in the long run and strong financial sound of the SMEs operations. However, an effective management tool, benchmarking can help operators identify and solve problems, find creative and innovative solutions, and formulate and implement strategies to improve performance. The cost of money, loan size and loan period are good predictors of financial performance in small businesses world over.

The Conceptual Framework



3.0 Review of Literature

The lending terms and financial performance related literature was reviewed, critiqued both the meaning of SMEs, sources of finance, lending terms, performance of SMEs and the relationship of the two variables

3.1 Lending Terms

The terms of the credit deal with the loan period, cost of money and loan size. They are mainly credit terms that stipulates the conditions under which credit is given based on the borrowing charges related to the loan (pandey, 1995). He also emphasized that the charge of using money borrowed on credit for a given stipulated short period with high interest rates hinders SMEs access to financial services like Uganda..

3.1.1 Cost of money

Whited (2004) in his contemporary study on rural finance argued that the cost of money is intended to compensate a contractor for the capital cost of employing certain facilities in the performance of contract. The cost of money charged by lending institutions includes operating costs, administrative costs, and an acceptable rate of return (levasseur, 2002). He also cited the studies of Heath and Gibson (1991) that cost of money may be fixed for the term of the loan, or adjusted to reflect changing market conditions. Adams et al (1984) also concurred with the above authors that the cost of money is looked at on the SMEs borrowing side as the charges paid for borrowing from financial institutions and mention four main components of cost of money are reflected as cost of funds, loan loss expenses, operating expenses, and profits. Indeed, they added that MFIs charge high cost of money to their low-income borrowers because SMEs have a tendency not to keep proper financial records and difficult to confirm their financial performance in the near future. Altman et al (1998) indicated that it's labor-intensive to deliver tiny loans to large numbers of SMEs without collateral and making loans to low-income enterprises is a risky business. He contended that most MFIs charge high cost of money far below rates charged by commercial banks. Pulfer (2008) in his study of interest rate analysis of local and international banks found that the interest rate is 39% compared to 10% and 14% for international development banks and banks respectively. This implied that MFIs use personal contact as a substitute for formal collateral or computerized credit scoring (Rosenberg, 2008). He also agreed that the costs of making a small loan will always be higher in percentage terms than the costs of a larger loan. Brigit et al (2004) in his empirical review identified three types of costs need to be covered by cost of money: the cost of funds for on-lending, the cost of risk (loan loss), and administrative costs (identifying and screening clients, processing loan applications, disbursing loans, collecting repayments, and following up on non-repayment). Rosenberg (2008) in his microfinance analysis further showed that MFI clientele are varied and consist of high risk borrowers due to the nature of their core business. He also found that some are concerned with access to financial services and willingness to pay the cost of the loan borrowed because it's only alternative available source of finance. He also added that the global average interest rate is about 35 percent, but the average in Mexico is above 60 percent and in Sri Lanka is below 20 percent. Small loan sizes are the most commonly cited reason why microcredit rates are higher than normal bank rates because microcredit is a "high-touch" business, and MFIs have to process thousands of tiny transactions. Rosenberg (2008) concluded that there is strong empirical evidence that operating costs are much higher for tiny microloans than for normal bank loans and therefore, Some few MFIs had charged their borrowers cost of money that seem considerably higher than what would make sense.

3.1.2 Loan size

Rosenberg (2009) in his study findings supported financial institutions that prefer large loans because the administrative costs decrease proportionately to the size of the loan. Kalema (2008) conducted a research study on access to financial services in Uganda and found that the average loan size was under Ugx300, 000 (\$180) and loan terms are generally between one and twelve months. Because of the small size of SMEs combined with small loans means that lending rates are typically in excess of 30 percent to reduce the risks involved in unsecured lending. On the contrary, IMF financial sector assessment (2003) reported that this is unattractive means of financing SMEs activities. the report further continued that most low income SMEs are better advised to defer borrowing until they have the necessary finance rather to borrow at such rates. Various studies also indicated that most SMEs consider small loans amount to meet immediate needs because SMEs don't capacity or experience to handle large sums of money in their businesses and even can lead to business failure. Loans are given depending on your savings with financial institution and the SMEs previous loan repayment. Most of these loans are lent out depending on the collection convenience, payment and flexibility with experienced clients. Ffinancial institutions tend to meet their clients working capital by giving short term loans and limit long term loans. Financial institutions cite weak SME management and governance, unreliable financial information on SME operations, lack of medium- and long-term resources for typical SME lending, and complicated procedures to register and seize collateral as the main constraints to funding SMEs with large loans amount (Rennie and Laurens, 2008)

3.1.3 Loan period

The IMF report (2007) attributes that lending is predominantly short term and low to SMES due to poor credit

discipline, contractual enforcement problems, and scarcity of projects and lack of collateral. Despite SMEs' perceptions of excessively high interest rates, the cost of finance is found to compare favorably with and generally the issue relates to the amount (monetary value) of the installment as opposed to the cost of credit. When installments are high (due to inadequate loan maturities or inadequate product structure) the cost of money is perceived to be high (Rennie and Laurens, 2008). Low installment amounts represent a much higher cost of money, are perceived as being less expensive. The maturity of loans is also a serious issue, as Uganda seems to have the shortest average loan maturity (12 months) among comparable countries such as Kenya, Brazil, China and India (CGAP report, 2009). The MFIs short term loans are not conducive for rural farmers who rely on climatic conditions to pay the loans and long term loans are not available to cater for animal production which are costly and risky. The financial institutions credit terms are recognized to meet SMEs working capital not for asset accumulation in the long run and limited access to loans of not more than 12 months (Kalema, 2008). Wellen and Mulder (2008) asserts that shorter term credits will prevail. This direct impact on SMEs will be noted when attracting new funding; loan period will possibly be shorter as the MFIs might be afraid that they are not able to pay their own loan because they are less sure that they will get their outstanding credits back. They concluded that some MFIs require borrowers to make compulsory deposits before they can receive a loan; borrowers typically must maintain these deposits during the life of the loan. The costs of money borrowers receive on these deposits are well below the rates borrowers pay on their loans. The effect of such deposit requirements is to reduce the net additional cash borrowers realize from their loans and, thus, to increase the effective cost of the loan to them. About one-third of the sustainable MFIs reporting to microfinance information exchange for 2006 required such savings deposits, and on average these MFIs are smaller than the ones that do not use compulsory savings (Rosenberg & Gonzalez, 2009)

3.2. FINANCIAL PERFORMANCE OF SMEs

Some writers believe that the performance of SMEs is measured by many factors such as internal and external to the SMEs themselves (Kotey and Meredith, 1997; Pearce and Robinson, 2002). They cited sales turnover, caliber of management and ability to meet daily obligations of the business. However, there are few studies on performance measurement of the SMEs and there is only small number of researches in developing countries (Bjerke, 2000). In the last two decades, it seems that researches on SMEs focus on government role and policy in developing SMEs (Ainuddin and Saodah, 2001). In year 2000, Hashim (2000) used strategic model approach to explain the financial performance measurement of SMEs. Craig and King (1988) also formulated a model to find out about SME performance. Financial measures are typically derived from or directly related to the chart of accounts and found in a company's profit and loss statement or balance sheet, such as inventory levels or cash on hand. Kaplan & Norton (1996:21) remarked that historically, the measurement system for business has been financial. A few centuries later, during the age of exploration, the activities of global trading companies were measured and monitored by accountants' double entry books of accounts (Kaplan & Norton, 1996:21). Moreover, in the information age environment, the early twentieth century, enterprises understood the importance of reporting and evaluating of business unit performances, in order to find new capabilities for competitive success (Olve, *et al.* 2001:13). In the last decade there has been a growing criticism of traditional measurement control systems as being too narrowly focused on financial measures. The reason is that conditions today are no longer the same as when traditional measurement systems emerged. In addition, markets fluctuate, customers appear ever more demanding, and investors are requiring more transparent reporting (Ashton, 2001:80). The increasing interest has been driven by the increased rate of change in the business environment in both the private and public sectors. This rapid change has led to general dissatisfaction with traditional issues of performance measurement systems, identifying their shortcomings and arguing for change (Neely, 1998:3). According to Zairi (1996:390) "today's management accounting information, driven by procedures and cycles of the organizations financial reporting system, is too late, too aggregated, and too distorted to be relevant for managers planning and control decision. Managers need clear, timely and relevant signals from their internal information systems to understand root causes or problems to initiate corrective action and to support decisions at all levels of the organization". Financial measures showed the effect of decisions already taken (Olve, *et al.* 2001:13). Therefore, they also agreed that management control must take account of non-financial factors and be broadened to include strategic information, which will indicate whether or not the business will continue to be competitive.

Mohinder & Anastasia (2007) also qualify multiple organizational financial performances like profit, cash flow and assets. Furthermore, Fabbri and Klapper (2008) added that profitability has been most widely used measure of financial performance of SMEs. Profitability is the excess revenue over expenses, which can be seen by the ratios like gross profit margin and pre-tax profit margin. They further argued that profits have got a lot of shortcomings as a measure of performance. Some economist and accountants view profitability differently and it

has received a lot of criticisms from many studies as the reasons are given below. From all the above definitions, it can be said that performance is the ability of the firm to meet both its long term and short term goals efficiently and effectively. The understanding of the important performance measurements of SMEs will help toward better planning to cater for the needs of the SMEs. Irwin (2001) cited that many people find it difficult to look at a profit and loss statement or a balance sheet and derive a full picture. As result, ratios are often used to interpret accounts. They indicate how a business is performing and provide indications of trends and patterns. They also supported that it can be compared to the same ratios in previous years' accounts and the accounts of other business operating in a similar environment. It can be noted that therefore, due to the nature of SMEs, it's difficult to measure the levels of profitability as they rarely keep proper books of accounts, seasonality of business operations, sensitivity of business information, and analysis and valuation problems (barrow(1997), Lisa (1999), liedholm (1991) and blank (2002). Measurement of financial performance by ratio analysis helps to identify enterprises strength and weaknesses by detecting financial anomalies and focusing attention on issues of enterprise importance. Ratio analysis is a well established tool to evaluate an enterprise's profitability, liquidity and financial stability (Glynn et al, 2003). Financial ratios are normally used in interpreting financial statements and comparison of other company's results in the similar industries or different industries in order to gauge the performance of the companies sector over a given period of analysis. Dobbins et al (2002) also argued that it can provide a predictive past and present performance of the company and able to point out the weak areas of the company. Financial performance can be measured using return on equity, solvency, sales growth, liquidity and profitability (lavasseur, 2002). According to Blank (2002), sales growth is the good measure of the SMEs financial performance because we are able to look at the sales turnover and the market share in the market, increase in profits and customer base maintained for a company to breakeven. He further agrees that the ability of the SMEs to meet all their financial obligations, asset accumulation and number of years in business is the good measure of financial performance. Other scholars argued that repayment capacity of SMEs measures shows the degree to which cash generated from the enterprise and other sources will be sufficient to pay principal and interest payments as they come due. For the purpose of this research, performance will be looked at in terms of solvency, financial efficiency and liquidity.

Solvency gauges the business's ability to pay all financial obligations if all assets are sold or continue viable operations after financial adversity and measured by debt to asset ratio, debt to equity ratio and equity to asset ratio (Dobbins *et al*, 2000). The higher the long term solvency, the more substantial the buffer for difficult times. According to Williams (2004) asserts that having a debt-asset ratio of zero is not necessarily a desirable goal either. It should be earning higher return on equity than debt. However, a high debt-asset level involves a higher degree of financial risk. While higher levels will require a higher return on assets to service the debt.

Rosenberg (2008) stated that liquidity of the SMEs should be able to meet short- term obligations of the business or a company's ability to pay current liabilities. (Boehlje *et al*, 1999) also supported that its ability of a business to meet financial obligations as they come due in the short term, without disrupting the normal operations of the business and its measured by current ratio which shows basic indicator of short-term debt servicing and/or cash flow capacity and the extent to which current assets, when liquidated, will cover current obligations. They further argued that SMEs face financial constraints due to insufficient cash flows to settle off the debts incurred. MFIs amount of loans in default as a percentage of the total loan portfolio increased by four percent to 12 percent in the first six months of 2009, according to the central bank of Uganda report. The National Bank of Uganda (NBU) reported that increase in the delinquency rate is due to the failure of loan holders especially SMEs to honour their debt obligations, hence a significant loss to MFIs. It can be measured by current ratio by dividing current assets over current liabilities and quick ratio by dividing Cash plus debtors over current liabilities. According to Kalema (2008) SMEs do not have the quality of the asset that makes it easily convertible into cash with little or no risk of loss and failure to meet the desirable liquidity range acceptable worldwide.

Financial efficiency measures the intensity with which a business uses its assets to generate gross revenues and the effectiveness of production, purchasing, product pricing, financing decisions (Dobbins *et al*, 2000). The management of assets and liabilities is particularly important in the case of small and medium-sized companies. Most of these companies' assets are in the form of current assets. Also, current liabilities are one of their main sources of external finance in view of their difficulties in obtaining funding in the long-term capital markets (Petersen and Rajan, 1997) and the financing constraints that they face (Whited, 1992; Fazzari and Petersen, 1993). In this respect, Elliehausen and Woken (1993), Petersen and Rajan (1997) and Danielson and Scott (2000) show that small and medium-sized firms use vendor financing when they have run out of debt. The assets are measured by stock turns, debtors' turns and sales to assets and efficiency with which managers use assets to generate profits. The financial strength of the company is the good asset management and accumulation and guarantees the company future ability of meeting business risk in term of good return on assets (Pedro et al,

2004). Effectiveness is assessed by relating net profit to the asset utilized in the generation of profits. From the owner's point of view, profitability means the returns achieved, through efforts of management, on the funds invested by the owners (helfer, 1991)

3.3 Relationship between Lending Terms and Financial Performance of SMEs

3.3.1 Cost of money and financial performance

Gonzalez and Sushma (2009) argued that today, there's widespread agreement that most MFIs should operate sustainably, keeping their costs as low as possible and charging interest rates and fees high enough to cover those costs. Inability to access finance may be one of the reasons why we do not see a robust correlation between SME prevalence and economic growth and financial constraints are particularly preventing small firms from reaching their growth potential in terms of financial performance (Demirgüç, 2005). The authors further asserts that in most situations SMEs ought to pursue financial sustainability by being as efficient as they can but MFIs charge high cost of money to cover the costs of their lending and other services. Rosenberg (2009) concurs with Gonzalez and Sushma (2009) that the cost of money charged to SMEs represents money taken out of clients' pockets, and it is unreasonable if it not only covers the costs of lending. Even the cost of money that only covers costs and includes no profit can still be unreasonable if the costs are excessively high because of avoidable inefficiencies and resulted to poor consistence financial performance of SMEs. There is an inverse relationship between cost of money and financial performance because the low cost of money can lead to improved performance on SMEs activities while high cost of money leads to stagnated performance and SMEs businesses collapsed in the short period due to non-existence of financial records (Demirgüç, 2005)

H1: There is an inverse relationship between cost of money and SME performance.

3.3.2 Loan period and financial performance

There are obviously many dominant factors that could influence an MFI to give short, medium and long period for a loan to the SMEs due to high cost of resources (funds), high competition, unclear client credit history, security offered for loan, and loan sizes (Suran, 2009). Pulfer (2007) added that in microfinance, the type of lending product is very short-term, low value, and to clients with no good credit histories. Guttman (1994) also concurred that short-term loan is from overnight to less than one year which makes SMEs not to perform well in their operations because of big installment payments to be remitted back to the MFIs in the short time like weekly, fortnight and monthly payment since the loan grows bigger in the given time with high interest rates charge. The loan period given is not suitable for SMEs performance in the current economic crises (Lascelles, 2009). However, loan period of lending to SMEs can contribute positive performance and enhances the SMEs business operations and expansion to its survival and productivity in achieving it goals and objectives in the short period of time. Contrary to the above authors, prior researchers have shown that SMEs can perform well in the shorter period as well as they are able to maintain their financial records in order to ascertain their financial credit worth (Suran, 2009).

H2: There was a positive relationship between loan period and SME performance

3.3.3 Loan size and financial performance

Empirical evidence suggests that borrowers who take loans from more than one MFI are more likely to default on their loans repayment and drops to 50% for households with membership in three or more MFIs because of the small loan size borrowed from one MFI (Martin et al, 2002). SMEs overstrained in their repayment capacity by several loans, poor capacity to pay, misuse of loan, no adequate income generation, un willingness to repay, utilizing for repayment of old loans (Christoph, 2008). This has related effect on the working capital of the business as they tend to have poor business performance and later disrupts the management capacity of the business owners. Regarding the borrowers' stress from the loans, this hinders the financial performance of SMEs leading to non-performing loans and diversion of the loan borrowed for a different purpose (Roodman, 2009). SMEs tend to lose commitment of repaying the loan because of the small loan amount borrowed and there is high possibility of not performing to the expectations of the MFIs since they also don't meet SMEs needs as they expect to bigger amount of loans (Cane, 2009). While the loan size can have some impact on the SMEs performance but it is minimal compared with those of big loan size in the same sector and its relationship to create good performance is insignificant to this kind of businesses (Cane, 2009). Micro enterprises activities are short term in nature and financial assistance which tend to meet business operational needs in the short period leading to low wealth accumulation and financial performance of SMEs. However, the study also showed that the rate of poor financial health state and failure of businesses in Uganda was also one of the highest in the world, citing that for every business that was started nearly one other closed. Mostly, these are micro enterprises (GEM

report, 2004)

H3: *There is a relationship between loan size and SME performance*

3.3.4. Costs of money, loan period and loan size are good predictors of SMEs performance.

According to Blank (2002), costs of money, loan period and loan size are good predictors of the SMEs financial performance because we are able to look at the sales turnover, payment ability, good returns in assets and the market share in the market, increase in profits and customer base maintained for a company to breakeven. He further agrees that the ability of the SMEs to meet all their financial obligations, asset accumulation and number of years in business is the good predictor of financial performance. Beck, Demirguc-Kunt and Martinez Peria (2008) report that the average share of SME lending is smaller in developing countries (16 percent of total lending) by comparison with the average share in developed countries (22 percent of total lending) gives contradicting predictors of SMEs performance. Banks in developing and developed countries are primarily attracted by the potential profitability of the SME sector and serve SMEs primarily through dedicated SME units. Government programs are considered favorable and prudential regulations are not perceived as burdensome. Scoring models are used by most banks but they are just one of the inputs in loan decision. Banks in developing countries report that macroeconomic instability is the main obstacle to SME lending and also affecting their performance, rather than flaws in the legal and contractual framework. However, the second study by Beck, Demirguc-Kunt and Martinez Peria (2009) based on the statistical analysis of the dataset concludes that the differences in SME lending between developing and developed countries are actually explained by differences in the quality of the legal and contractual environment (weaker in developing countries). Overall, their analysis suggests that the enabling environment is more important than firm size or bank ownership in shaping bank financing to SMEs and it may not be a good predictor of SMES performance in such areas of operation.

H4: *Cost of money, loan period and loan size are good predictors of SMEs performance.*

4.0 Research Methodology

The study used a cross-sectional survey and descriptive research design mainly because previous research has preferred this approach over the qualitative and longitudinal one (Sabit, 2002). The survey was conducted in March, 2011 to January, 2012 using administered questionnaire, face to face interview on a sample size of 108 SMEs selected by purposive random sampling from the 150 SMEs operating in Soroti District Municipal Central Division at the time.

The independent variable (lending terms) was measured by cost of money, loan period and loan size while the dependent variable (financial performance of enterprises) by solvency, liquidity and financial efficiency. The cost of money was measured in terms of the percentage rate and Loan period in terms of months in which micro enterprises should have completed the loan in time. While loan size in terms of the loan amount borrowed by the microenterprises. Financial performance was also measured using ratio analysis (Kaplan and Nortion, 1996). Financial efficiency was measured by stock turns and sales to assets and efficiency with which managers used assets to generate profits, liquidity by current ratio by dividing current assets less inventory over current liabilities and quick ratio by dividing Cash plus debtors over current liabilities (Abraham, 2004) and solvency by debt to asset ratio, debt to equity ratio and equity to asset ratio. Responses were obtained from 108 SMEs representing 76% response rate of the sample and analysis was done. Data collected, entered, coded, tabulated and analyzed .using both qualitative and quantitative approaches. The data was analyzed using statistical package for social scientist (SPSS Version 16.0) for mean, frequency, graphs, tables, percentages, correlation and regression to ascertain the relationship between lending terms and Performance of SMEs. The instrument was measured by the response of the SMEs on the lending terms on the loans borrowed during the period 2010. The year had high inflation rate of above 15% and interest rate on lending was above 28%. Financial performance ratios were obtained from their financial statements used to obtain the bank loans from the financial institutions. The Cronbach coefficients ranged from 0.871 and 0.921 of the variables. A measure designed to assess effect of lending terms variables each rated on a 5-point Likert scale ranging from 'strongly disagree' to 'strongly agree'.

5.0 Results

5.1 Lending Terms to Small Medium Enterprises

Analysis of percentage frequency distribution of the cost of Money

The SMEs are widely managed by male (68.3) and female (31.7), operates mostly in trade and commerce sector (73.2%) as compared to manufacturing and service sectors (11%). 52.4% of SMES had started business with their own personal savings, borrowing from microfinance (12.2%), business angels (11%) injected by family members and followed by others (9.8%) by sale of agricultural inputs and pension. While 53.47% of SMEs had sales annual turnover between 10-50 million and followed by 50-100 million (23.2%) implying that they were

able to meet their current obligations. Most financial institutions were charging interest rates (18%-24%), Insurance fees, legal fees and default fees (below 1%), Commitment and monitoring fees (1%-3%). **[Insert table 1 here]**

Analysis of Factor structure of the lending terms of financial institutions

The financial institutions were charging high interest rates to small medium enterprises since the interest rate is above 2.5, as by shown by the response mean of 2.76 indicating a significant variation in responses to the study. However, by reducing liquidity in the economy, the Central Bank also sparked off a rise in commercial bank lending interest rates. Between July and October, Bank of Uganda increased its lending rate to commercial banks from 13 per cent to 20 per cent, resulting in a corresponding increment of commercial bank lending rates to their clients from between 21-24 per cent to nearly 30 per cent (BOU, 2010/2011). The Factor structure of the lending terms of financial institutions clearly showed that the cost of money (55.457%) had the majority influence in lending terms of financial institutions while loan period and loan size had negative influence in lending terms. Loan size (13.05%) acquired from another financial institution had a less influence to lending terms of financial institutions. **[Insert table 2 here]**

5.2 Financial performance of SMEs

On the financial performance, Small medium enterprises had liquidity of 1.3040:1(Current ratio) and 0.3226:1 (Quick ratio) on average. However this liquidity position is within the range of 1.5:1 to 2:1. The result is that they can pay obligations arising within one year using the available current assets. In order to understand better the liquidity position of the businesses, quick ratio is most considered since the ratio is below the recommended ratio. Small medium enterprises had a financial efficiency level of 2.3460 and 3.4573 for sales to assets and Inventory turnover respectively. While On average, the small medium enterprises had a solvency level of 5.5168, 0.6170, and 1.0391 for debt to assets, debt to equity and equity to assets ratios respectively. This ratio is higher than the recommended maximum of 0.4. It implies that on average small medium enterprises had total financial obligations equal to about 551.68%, 61.70% and 103.91% of their total assets. This means during difficult times, they are not able to offset all their liabilities using just total percentage of their total assets. This indicates that the small medium enterprises have a lower buffer for difficult times. **[Insert table 3 here]**

5.3 The relationship of the variables

The correlation analysis of the research hypothesis

H1: showed a positive significant relationship between cost of money and financial performance ($r= 0.324$, P-Value<0.01). This implies that as the cost of money increases, the performance of SMEs decreases.

H2: showed that there is a negative relationship between loan period and financial performance ($r= -0.323$, P-Value<0.01). This implies that the loan period does not affect financial performance of SMEs.

H3: shows that there is a negative relationship between loan size and financial performance ($r= -0.322$, P-Value<0.01). This implies that the loan size does not influence the financial performance of SMEs.

H4: showed that cost of money is the only good predictor of small medium enterprises' performance while loan period and loan size are not good predictors of financial performance. However, all of them contribute differently to financial performance in both negatively or positively. **[Insert table 4 here]**

The multiple regression analysis of the variables

The regression model indicated that lending terms significantly affected the financial performance of SMEs ($F = 10.796$, $\text{sig} = 0.000$). Furthermore, it was found that the lending terms (loan size, cost of money and loan period) explained 26.6% of the total variance in the financial performance of the selected SMEs under this study. This implies that 26.6% of the variations in the financial performance are as a result of the different lending terms used by the financial institutions. Loan size contributed more to performance ($\text{Beta}=0.012$) followed by cost of money ($\text{Beta}= -0.038$) and lastly loan repayment period ($\text{Beta}= -0.580$) **[Insert table 5 here]**

6.0 Discussion

The lending terms indicated that cost of money contributed positively than loan size and loan period. Therefore there are less significant contributions attached to cost of money in terms of access to finance, asset wealth creation and affordability to borrow from the financial institutions. The costs of money charged by financial institutions to SMEs are high and unfavorable as they significantly increase the cost of borrowing. The Findings had varying arguments with the literature as some are concerned with access to financial services and willingness to pay the cost of money borrowed because it's only alternative available source of finance. This view is supported by Rosenberg (2008) who contends that SMEs are more concerned about access to financial services from financial institutions than the cost of money because they want to have business growth in making more

profits and accumulate assets in the short term. The author further asserted that the global average interest rate is about 35 percent, but the average in Mexico is above 60 percent and in Sri Lanka is below 20 percent. Brigit et al, (2004) concurred with Rosenberg (2008) by contending that borrowing is an individual obligation to meet all the cost of money charged on the loan borrowed whether the cost of money is very high. Research findings on the Loan size shows that Small medium enterprises prefer small amount of loans depending on the size of the SMEs Asset wealth creation, ability to pay and making profits in the short period. The adequacy of the loan amount is valued as most important aspect in SMEs borrowing. Their small size of SMEs combined with small loans means that lending rates are typically in excess of 30 percent to reduce the risks involved in unsecured lending (Kalema, 2008). IMF financial sector assessment (2003) concurred with Kalema (2008) that this is unattractive means of financing SMEs activities because most SMEs consider small loans amount to meet immediate needs. Loans are given depending on your savings with financial institution and the SMEs previous loan repayment. The author further asserted that most of these loans are lent out depending on the collection convenience, payment and flexibility with experienced clients. Most financial institutions tend to meet their clients working capital by giving short term loans and limit long term loans.

Findings on the loan period indicate that the loan period contributed less than cost of money but contributed less than loan size. Therefore, it means that owners consider less importance to loan period than cost of money in creating more assets, ability to meet daily obligations and reducing the possibility of loan default.

The liquidity levels of small mediums enterprises were able to offset their obligations within one financial year. However, it is slightly above the recommended by the (Boehlje *et al*, 1999), otherwise it is not excessive since it's within the ratio range. On the contrary, Kalema (2008) argued that SMEs do not have the quality of the asset that makes it easily convertible into cash with little or no risk of loss and failure to meet the desirable liquidity range acceptable worldwide. Rosenberg (2008) also contended with Kalema (2008) that SMEs put a lot of money on idle debtor's balances and little on inventory.

The solvency of SMEs showed that on average, the solvency level of SMEs is not good. Because solvency level is not desirable since it is not in line with recommendation by Williams (2004) who contended that the solvency range that is desirable is less than 0.4. The effect is that SMEs had a total debt level bigger than assets levels. Dobbin et al (2000) also asserts that a high debt-asset level involves a higher degree of financial risk. While higher levels will require a higher return on assets to service the debt. Since most SMEs can meet their obligations with a large portion of their assets which is above the recommended minimum. However, SMEs growth is limited as they concentrated to meet financial risk of their businesses.

The third research objective sought to establish the relationship between lending terms and financial performance and the findings showed significant positive relationships between cost of money and financial performance while loan size and loan period showed negative relationship. Although most of the SMEs extensively accessed credit in their efforts to boost their liquidity, solvency and financial efficiency. This probably meant that most of the SME's under study had poor credit payment which needed attention. This is in agreement with Demirgüç (2005) that inability to access finance may be one of the reasons why we do not see a robust correlation between SME prevalence and economic growth and financial constraints are particularly preventing small firms from reaching their growth potential in terms of financial performance. Rosenberg (2009) also concurred that the cost of money that only covers costs and includes no profit can still be unreasonable if the costs are excessively high because of avoidable inefficiencies and resulted to poor consistence financial performance of SMEs.

7.0 Summary and Conclusion

On overall average, SMES are generally performing poorly. The average financial performance is not good because the actual sales and assets was low giving rise to a big negative variance. These shows that less assets than liabilities as indicated by liquidity ratios and solvency ratios. The liquidity of SMEs is within the acceptable range. So less capital is tied up in form of current assets like debtors and cash and bank balances. On the relationship, when lending terms reduces, the financial performance of SMEs tremendously improves. This shows that SMES needs better loan packages designed by financial institutions and also understand the nature and operations of SMEs in order to propelled their growth potential in creating more jobs, wealth accumulation and long term sustainability of their businesses. Loan size contributed more to financial performance followed by cost of money and lastly loan repayment period. Financial institutions when providing loans to SMEs also consider the size of the loan since SMES interest to get more loans to improve on their growth and performance. The findings meant that due to lack of agricultural lending to SMEs by the financial institutions to allow more SMEs to have access to funding to improve on the loan period given to them at lower interest rates to increase their performance in the long run affected the growth and development of SMEs sector in Uganda to expand and

move to acquire better technologies of doing business and add value to their products and services.

8.0 Recommendations

The following recommendations was based on the research findings

- SMEs owners should avoid trade credits since it can lead to high cash outflow of financial resources to the suppliers and reduce multiple loans to pay old loans
- The Study also recommends that SMEs should endeavor to prepare and keep proper books of Accounts to avoid deficit accounting. Theoretically, this study contributes to a number of debates
- Financial institutions should careful understand the SMEs nature of businesses in order to offer reasonable loan sizes and the booming seasons of SMES business so that they can give reasonable loan period which in turn leads to better financial performance.
- The study also proposed that a further research be conducted on lending terms and non-financial performance of small enterprises in Uganda, a longitudinal study on lending terms and financial performance of small mediums enterprises in Soroti and lending terms, managerial competences and investment performance of hotels in Uganda

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Appendices

Table 1: Percentage frequency distribution of the cost of money

Item	% Frequency	Mean	Standard deviation
Interest rate		2.76	1.243
Below 18%	1.2		
18% – 24%	43.9		
24% – 30%	20.7		
Above 30%	6.1		
N/A	28.0		
Commitment fees		2.33	0.994
Below 1%	15.9		
1% – 3%	48.8		
3% – 5%	4.9		
N/A	29.3		
Legal fees		1.73	0.610
Below 1%	56.1		
1% – 3%	8.5		
N/A	35.4		
Insurance fees		1.73	0.771
Below 1%	34.1		
1% – 3%	19.5		
N/A	46.3		
Default fees		1.35	0.616
Below 1%	20.7		
1% – 3%	7.3		
N/A	72.0		

N/A = means those SMES that had not borrowed from financial institutions:

Table 2: Factor structure of the lending terms of financial institutions

Item	Factor 1	Factor 2
Interest rate charged by financial institutions	0.872	
Commitment fees paid to financial institutions	0.84	
Legal fees paid to financial institutions	0.727	
Insurance fees paid to financial institutions	0.615	
Monitoring fees paid to financial institutions	0.728	
Loan repayment period in months offered to business	-0.991	
Size of loan acquired from banks by the business	-0.9	
Size of loan acquired from another financial institution		-0.906
Eigen value	4.991	1.174
Variance (%)	55.457	13.05
Cumulative Variance (%)	55.457	68.507

Table 3: Descriptive statistics for the financial indicators

Financial indicators	performance	N	Minimum	Maximum	Mean	Std. Deviation
Current ratio		82	.27	5.82	1.3040	.84966
Quick ratio		82	.01	3.28	.3226	.41966
Sales to Assets ratio		82	.01	6.85	2.3460	1.52385
Cost of sales to closing inventory		82	.74	17.09	3.4573	3.41057
Debt to Asset ratio		82	.00	33.58	5.5168	6.91887
Debt to Equity ratio		82	-4.55	6.43	.6170	1.31165
Equity to Asset ratio		82	-181.75	18.31	1.0391	20.99531

Table 4: The correlation analysis of the research hypothesis

	(1)	(2)	(3)	(4)
Loan size (1)	1			
Loan repayment period (2)	.668**	1		
Cost of money (3)	-.699**	-.801**	1	
Financial performance (4)	-.322**	-.323**	.324**	1

** . Correlation is significant at the 0.01 level (2-tailed)

Table 5: The multiple regression analysis of the variables

Multiple Regression analysis

Model	Unstandardised Coefficients		Standardised Coefficients	T	Sig
	B	Std. Error	Beta		
Constant	-9.049E-17	.095		0.000	1.000
Loan size	.016	.182	.012	.089	.929
Loan repayment period	-.580	.164	-.580	-3.524	.001
Cost of money	-.051	.228	-.038	-.222	.825
R-square	.293	Adjusted R square	.266		
F-Statistic	10.796	Sig.	0 .000		