

The impact of Debt Financing on Performance of Small and Medium Enterprises in Ghana

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Abstract — Small and Medium Enterprises (SMEs) are an essential part in the growth of the economy and industry as a whole. But in the long run, capital is needed to boost their performance hence the need to finance their operations primarily through debt. The scarce research on debt financing of SMEs leads to the purpose of this study to analyze the impact of debt financing on SMEs performance in Ghana. The SMEs sample used for the analysis was taken from Ghana Stock Exchange (GSE) database, which has forty-two (42) companies listed. It contains a comprehensive array of financial statements and balance sheets for companies active in Ghana. For the purpose of the study, 8 SMEs were selected based on their stated capital of not less than GHC 300,000. A five-year time frame financial account reports from 2015 -2019 consecutive year period were used for this study. Also, the study hypothesis was tested using multiple regression analysis. From the results of the study, debt-financed through both short and long term have a detrimental impact on SMEs' financial performance. With the intention to destitute credit and loan control policies, the study recommends that SMEs utilize their debt significantly. The diversification of their revenue streams, is essential to amateur down payment modes for trade credits and practice proper financial bookkeeping records. It is also suggested that transparency in payment schedules and necessity of training their employees on a regular basis. The employment of knowledgeable interior and exterior auditors to advance interior control systems and keeping of records is also advantageous for SMEs in accessing loans.

I. INTRODUCTION

The key aspect influencing the progress of Small and Medium Enterprises (SMEs) in both developing and developed nations across the globe is debt financing (Jepkorir & Gichure, 2019). In view of Begg & Portes (1993) business debtors in Central and Eastern Europe (CEE) also struggle to meet scheduled periodic interest payments to creditors, even banks or other companies. Given the fact that excessive debt could well drain out the investment of owners. Whilst most of the fastest-growing businesses are usually funded predominantly with equity. Kose et al. (2020) suggest debt accountability and efficient

debt management can help minimize funding rates. And further states it could improve debt sustainability as well as mitigate fiscal risks. The liability for businesses, precisely SMEs to receive funds from the government is quite limited. At the same time, others that cannot accept imbursement seek trade loans, short-term loans, and long-term loans from manufacturers, family, mates, commercial banks, and microfinance institutions (Olawale et al., 2010). In most developing countries majority of SME activities are performed in the informal sector. This also plays a major role in economic development. Perhaps to ensure

efficient growth for SMEs is essential to depend on debt financing through the acquisition of resources.

In respect to the views of (Addaney et al., 2016; Meher & Ajibie, 2018) with describing SMEs as a significant tool to economic growth which is comprehensively acknowledged in developing countries. Corresponding to decrease on the unemployment burden, in as much as there is an increase on income to the people and productivity in the industrial sector. Increased labor supply and productivity gains have indeed been contributory factors to Ghana's economic growth over the last two decades, reporting increased Gross Domestic Product (GDP) growth from (International Monetary Fund, 2019). The immense achievements of SMEs to the economic development and growth of the economy are quite tremendous. (Sam Mensah, 2004). The Registrar General Department initiated an online procedure for the registration of new business, which lead to a massive turnout in 2017. Sole Proprietorship registrations accounted for 58,504 of the nearly 87,000 companies registered in 2017, including online registrations reported by (Acquah-Hayford, 2018). He further stated in his report on The Business and Financial Times that; Company Limited by Shares registrations accounted for 21,700 and Company Limited by Guarantee registrations accounted for 5,754. Also, corresponding to the report from Ghana Statistical Service (GSS, 2012) SMEs account 70% of all industrial establishments, contributing about 70% of GDP and accounting for about 92% of Ghana's businesses. And over 60% of the working labor force is also consumed by SMEs market with majority in rural areas (GSS, 2012).

Begg & Portes (1993) perceived that the limitations of the business budget no longer bite, and the price mechanism loses much of its relevance in resource reallocation. Given the view of Lin (2020), the asset-liability ratio represents the ratio between a company's borrowed capital and its own capital. He further stated that debt leverage ratio indicator is used when addressing the topic of debt finance from the viewpoint of the business sector. With the operation of business through debt, leverage comes as an essential tool. Through the analysis and understanding of cooperating financial risk that would be encountered. Financial leverage can be used as a performance indicator for SMEs. Specifically for bank loans in the maximization of returns from the acquisition of investment. Hence, corporate debt is represented as leverage ratio = total corporate debt / GDP; (Lin, 2020) simplified, the debt leverage ratio as used as asset-liability ratio = liability / asset corresponding to the issue of debt leverage for certain corporations.

SMEs may contrarily be posed to face a vital challenge of financial resources, which may stifle the company's growth in performance and continuity. This circumstance poses a challenge for SMEs to improve the firms' results, as banks and other organizations evaluate their financial performance before doing business with them (Quaye et al., 2014). Moreover, past researches (Abor, 2004; Agyapong & Attram, 2019; Agyei, 2018; Fatoki, 2012; Kira & He, 2012; Obuya, 2017; Ye & Kulathunga, 2019) especially emphasizes the availability of finance, managerial competency, and financial literacy. Which have been highlighted as major factors influencing SMEs' success. These researches did not concentrate on how debt financing affects long-term and short-term financial efficiency in organizations. Hence resulting in a research gaps needed to be addressed. Precisely, the effort of this research paper has been purposed on the impact of financing through debt on the performance of Small and Medium Enterprises on economic growth in Ghana. This research work has motivated the zeal to fill this void and adds to the body of knowledge on the current debate about the impact of debt financing on SMEs' performances. From International Monetary Fund (2019) the increases in working population and human resources make up roughly half of GDP growth since 1990. Obviously, most of these people are employed by SMEs. Hence the need to solicit their funding in order to boost the activities aiming for effectiveness and efficiency in their performance. Furthermore, total factor productivity accounts again for the third, and physical capital accumulation accounts for the remainder (International Monetary Fund, 2019). These in some way attribute to the enhancement in the performance of SMEs. Factoring all these into consideration, it is essential to address the issue that affects SMEs performance relating to finance through debt.

II. LITERATURE REVIEW

2.1. Theoretical Review

Debt financing theories attempt to enlighten the contributions to the overall cost of capital and the company's value as the compositions of debt financing investments change (Jepkorir & Gichure, 2019). In the process of investigating the relationship between the variables selected for this research work with the extent of theories investigated. This study assumed some theories as guidelines for this research paper.

2.1.1. The Anticipated Income Theory

Financial factors should determine the worth of a company as economic income instead of accounting earnings. As the economic gain signifies the company's underlying earnings and cash flows. For the fact that, the

Anticipated Income Theory proposes that loan payments be related to a borrower's predicted income. Hence the performance of the firm (SMEs) is an essential factor to be considered in debt financing. Sales, earnings per share, and a firm's growth rate can be used to evaluate a company's (SMEs) performance. It corresponds with accounting-based performance which could be skewed by accounting standards. Though the measurement could be subjective and historical in their implementation. Also, debt finance may enhance the expansion of SMEs in this research context. If accounting statements and theories are geared toward the viewpoint that SME management wishes to enhance their performance.

2.1.2. Modigliani and Miller theory

In view of the Modigliani and Miller theory of capital structure that depicts the value of capital structure selected by a company does not affect its value. The value of SMEs will be maximized as it uses more debt than equity in its capital structure. With total capital cost decreased as debt would include in capital structure and profitability be increased (Modigliani & Miller, 1963). By contradicting this theory which might not be favorable with imbalance market in Ghana as a developing economy especially for SMEs. Akeem et al. (2020) stated that high cost of debt financing and tax shields on debt would impact the valuation of a business where it affect both cost of capital and the returns of investors.

2.1.3. The Agency theory

Also the concept of Agency theory could be considered as a sustainable tool in SMEs operations. Which could be used to examine and solve relationship problems among corporate principals as shareholders and their agents as company executives. There is evidence to suggest that the agent will never behave in the interests of the principal since relationships on both sides act as price takers (Jensen & Meckling, 1976). Meanwhile, it is extremely difficult for the principle or the agent to assure that the agent makes the best choice from the principle's perspective at no expense. Irrespective of the fact that the principle expects the agent to behave within the principal's best interests in an agency relationship.

2.1.4. The Keynesians economic theory

Keynesians' economic theory was developed during the world economy Great Depression around 1930's by John Maynard Keynes as an income and expenditure model (Amadeo & Brock, 2021). This new economics theory holds that the government should raise demand in order to boost inflation. As a result, the notion argued that an optimal level of economic performance may be attained. While downturns can be averted by stimulating market demand with government monetary policies.

Criticisms resulting from increased company growth, not consumer demand, according to supply-side economists, will strengthen the economy. The acknowledgment on government responsibility with the fiscal policy was directed toward businesses. Given rise to the new Keynesian theory in the 1970s. When deficit spending would encourage people to save money rather than promote demand or economic growth (Amadeo & Brock, 2021). The Keynesians Theory may have arose many economist and school of thought criticisms.

2.2. Empirical Review

Good debt management and accountability can help cut borrowing costs, improve debt sustainability and reduce fiscal risks (Kose et al., 2020). Since borrowed funds were normally transferred to uses that did not increase export profits, productivity, or potential output. It has led many researchers to question the acquisition of debt with implicit findings. Many research works have been carried out on the impact of exterior debt borrowing on the economy. While a few focused on the impact of debt financing on corporate performance. Given that their findings from these investigations are quite contradictory. In respect to Slav'yuk & Slaviuk (2018) survey on the tendency of indebtedness in 2008 – 2009 due to financial crisis on developing and advanced countries. Which stated that current needs and financial debt becomes an essential source of investment and development in the economy. And further factors it burdens the economy when growth turns to be unlimited. Irrespectively this could also be avoided through effective and efficient skills in debt management. This corresponds to Samuel et al. (2013) study on the Ghanaian economy, which states foreign direct investment serves as key source of economic growth in contributing to capital, technology, and management expertise. However, criticisms on the effect of external borrowings was argued on the drags debt as on the growth of the economy (Anning et al., 2015; Cunningham 1993). When debt reaches a certain level, it raises the debt rate which might not be favorable (Cunningham, 1993). But policymakers can manage and anticipate developing risks via supervision, avoiding financial shocks.

In order to operate efficiently and effectively, businesses require capital. They have the option of employing internal cash, debit, or equity to fund their operations successfully. The funding from financial institutions are used to raise debt finance. The financing role of microfinance institutions (MFIs) has favorable influence on SMEs (Quaye et al., 2014). The survey also highlighted certain risk mitigation measures employed by MFIs in awarding loans to SMEs. When assets are wisely invested, businesses may look forward to a bright future

(Rahman et al., 2019). Thus business performance comes as a result of the investment made in firms. As Meher & Ajibie (2018) study states debt finance has a favorable impact on the financial performance of SME firms, both in the short and long term. Respectively, debt overhangs could stifle investment for lengthy periods of time if bankruptcy laws are followed correctly. Also, deepening the financial markets can assist in mobilizing domestic savings, with a safer stable source of capital than international borrowing.

SMEs help to create a new economic performance that is more equitable. Regardless of the ability of SMEs to support and nurture economic progress in the Ghanaian economy. There are many identified studies with fundamental roadblocks impeding SMEs' contribution to national development with inaccessibility to capital (Antwi et al., 2013; Prezas, 1987; Quaye et al., 2014). Tiny businesses in Ghana will start tiny and ultimately disappear small, with little ability to effectively grow in terms of output or profitability.

The literature research included studies in many fields pertaining to the function of debt financing on SMEs' performance. Many SMEs have failed as a result of poor loan financing, which has forced them out of business (Anane et al., 2013; Meuleman & De Maeseneire, 2012). Suffering the consequence of business competitive environment and insufficient policy decisions to maintain their sustainability. The existence of several researches dealing with SMEs situations in Ghana would typically confirm a close examination of the literature research. Debt financing could also project to boost SME growth prospects. In this context, the research focused on the impact of financing through debt on the performance of SMEs in Ghana.

2.3. Objective of the Study

1. To define the effect of short-term loans on SMEs performance.
2. To determine the impact of long-term loans on SMEs performance.

2.3.1. Hypotheses of the Study

H₀₁: Short term loans has no significant impact on SMEs performance.

H₀₂: Long term loans has no significant impact on SMEs performance.

III. RESEARCH METHODOLOGY

3.1. Methodology

The steps corresponding to the scientific approach used to research the theories are; Review the previous studies on the importance of debt financing. Special emphasis on the relevance regarding debt finance on performance of SMEs in various industries ranging from food processing, real estate, and stationaries. And review the contributions of the growth on the performance of SMEs in Ghana. To examine the relevance of debt financing on the performance of SMEs in the sector. With an appropriate focus to moderating role of the SMEs performance efficiency in economic growth as a knowledge gap. The key methods of this study develop an econometric model of Multiple Linear Regression Model. It is used to test the relationship of debt financing on performance of SMEs on with their short and long term loan. And also a survey on retrospective implication to the economic growth study on companies like SMEs in their business operations. The focus objective of the analysis is to determine the effect of growth performance on SMEs sustainability through debt financing.

Multiple Linear Regression model would be employed as an econometric model. It assesses the association between two or more independent variables and single or multiple dependent variables. The econometric model representing the dependent and independent variables;

$$Y_i = \beta_1 + \beta_{1X_1} + \beta_{2X_2} + \varepsilon$$

Where; Y_i ($i = 1, \dots, 3$) represents Profit Margin, Return on Equity, Return on Asset.

X_1 represents Short Term Loan

X_2 represents Long Term Loan

ε represents Error Term

3.2. Study Sample

Secondary data is mainly used for the purpose of this study. The SMEs sample used for the study was taken from database of the listed companies on the Ghana Stock Exchange (GSE). The data from GSE dataset are used to derive the variables for the study. It contains a comprehensive array of financial statements and balance sheets for companies active in Ghana, with 42 companies listed on their database. For the purpose of this study, 8 SMEs were selected based on their stated capital of not less than GHC 300,000. These SMEs consist of different industries being in operation for about a decade, and the analysis obtained from the financial statement and balance sheet reflecting a five-year period from 20015-2019 was used for the study.

Table 1: Measurement of Variables

Variables	Measurement	Type of Variable
Profit Margin Ratio	Gross profit / Sales or Turnover	Dependent
Return on Assets	Net Income / Total Assets	Dependent
Return on Equity	Net Income / Total Equity	Dependent
Current Ratio	Current assets / Current liability	Dependent
Long term debts ratio	Long term loan / Total loan	Independent
Short term debt ratio	Short term loan / Total loan	Independent

Table 2: SMEs listed under GSC

Symbol	Company Name	Sector	Year Listed
ALW	Aluworks LTD	Basic Material	1996
BOPP	Benso Oil Palm Plantation LTD	Consumer Goods	2004
CLYD	Clydestone (Ghana) LTD	Technology	2004
CMLT	Camelot Ghana LTD	Industrial	1999
HORDS	HORDS LTD	Consumer Goods	2015
MAC	Mega African Capital LTD	Financial	2014
SAMBA	Samba Foods LTD	Consumer Goods	2015
SWL	Sam Wood LTD	Consumer Service	2002

3.2.1. Study Variables

Two sets of variables, dependent and independent variables are employed in this study. The dependent variable which is presumed to be influenced by the other variables. The dependent variable to be considered in this study is performance of SMEs using profit margin, return on asset, and return on equity. As a performance measurement indicator to determine the financial performance of SMEs through debt financing. Whereas independent variables are the cause of influence. Hence, the independent variables to be considered are short term loans and long term loans as the debt finance measurement indicator for this study. In order to capture the moderating

effect of SMEs performance on the relationship between debt financing and the value of SMEs these variables are significant.

IV. FINDINGS AND DISCUSSIONS

For this study, the standard deviations, as well as the means for all variables relating to the study, were computed to ascertain a fair opinion regarding the path of each variables, thus; return on assets, profit margin ratio, short term debt ratio as well as long term debt ratio. The descriptive statistics for the dependent and independent variables are displayed inside the tables below.

Table 3: Descriptive Statistics

	Min	Max	Mean	Standard Deviation	Skewness	Kurtosis
Profit Margin Ratio	0	3.622	0.631	0.249	(0.741)	0.105
Liquidity Ratio	0	3.243	0.578	0.121	0.981	0.075
Return on Asset	0	2.641	0.512	0.269	0.803	0.196
Long-term Debt Ratio	0	2.624	0.384	0.225	-0.813	0.41
Short-term Debt Ratio	0.02	0.933	0.513	0.330	0.944	0.269

Performance	0	4.342	0.728	0.224	0.231	0.330
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Observation from the Table signifies the average of profit margin (PMR) at 63%, liquidity ratio at 57%, and ROA at 51%. Also, an indication as resultant from long term loans and short term loans from Enterprises shows averages of 38% and 51% respectively. Corresponding

from the values, all standard deviations are valued at below the mean showing a small coefficient of variation. Substantially, there is a minimum and maximum range of variation.

Table 4: Correlation analysis

	Profit margin ratio	Liquidity ratio	Return on asset	long term debt ratio	short term debt ratio
Profit margin ratio	1				
Liquidity ratio	0.347**	1			
Return on asset	0.253**	0.036	1		
long term debt ratio	0.068*	-0.145*	-0.043*	1	
short term debt ratio	-.485**	-.367**	-.340**	-0.126	1

* At 0.01 (1%) confidence level, correlation is significant (1 tailed).

**At 0.05 (5%) confidence level, correlation is significant (2 tailed).

By looking at the Pearson correlation, it clarifies that the variables are related to each other to some extent. The correlation analysis table, reveals that the long-term debt ratio has a significantly negative association with the liquidity ratio. Thus, ($r = -0.145$, $\text{value} < 0.05$). This outcome translates that the long-term borrowings or debts of the companies selected had an adverse effect on performance, in this case liquidity ratio. From this same results, the long term debt ratio has a negatively significant association with return on assets ($r = -0.043$, $\text{value} < 0.05$),

implying the long term borrowing or debt had a negative influence on return on asset.

On the short term ratio. It was revealed that it showed a negatively significant correlation with profit margin ratio, liquidity ratio and return on assets. Thus, ($r = -0.485$, $\text{value} < 0.01$), ($r = -0.367$, $\text{value} < 0.01$) and ($r = -0.340$, $\text{value} < 0.01$) respectively. These outcomes suggest that both short and long term debt ratio is adversely correlated with their performance measured in terms of return on asset, profit margin ratio and liquidity ratio.

Table 5: Results of Regression

	Model 1, Dependent Variable: Profit Margin Ratio		Model 2, Dependent Variable: Liquidity Ratio		Model 3, Dependent Variable: ROA	
	Beta	T	Beta	T	Beta	T
Long Term Debt Ratio	-0.005	-0.037	-0.157*	-2.092	-0.09	-1.043
Short Term Debt Ratio	-0.547	-6.595	-0.387*	-5.176	-0.347*	-4.591
ANOVA (F ratio)	16.726		0.43		0.49	
ANOVA (Prob)	0		0.273		0.384	
R Square	0.286		11.97		8.519	
Adjusted R Square	0.27		.000a		0	

Dependent variable: return on the asset; liquidity ratio; profit margin ratio

The regression results for this study is presented in table 5. The global statistics (adjusted R Square) shows that 27% of the variation in the predicted variable are caused by changes in the predictor variable. From m this table, there is more than enough evidence to suggest that long-term debt negatively affect all the dependent variables. Thus; liquidity, profit margin and asset yield having statistical outcomes of ($\beta = -0.157$, $p < 0.05$), ($\beta = -0.005$, $p < 0.05$) and ($\beta = -0.09$, $p < 0.05$) respectively. We then reject the null hypothesis, which states that long term debt has no significant influence on the financial performance of the selected firms

On the short-term debt ratio, the regression results were equally the same as with the long-term debt ratio. There was a negatively significant relation between short-term debt and liquidity, profit margin, and asset yield ($\beta = -0.387$, $p < 0.05$), ($\beta = -0.547$, $p < 0.05$) and ($\beta = -0.347$, $p < 0.05$) respectively. There is enough evidence not to accept the null hypothesis, which states that no significant relation exist between short-term debt and financial performance.

V. CONCLUSION

To be more precise, the study employs both classic and unorthodox theories to motivate its empirical section. And it explains the influence of debt finance on the financial performance of SMEs precisely in Ghana. Modigliani & Miller (1963) amended their remark of 1958, noting that an increase in debt on a company's capital structure might result in greater performance because of tax-deductible interest payments. Accordingly from the data, it shows that SMEs financial performance in Ghana has been impacted through their debt finance. The use of debt has a statistically significant negative association with performance metrics, including liquidity, profit margin, and return on assets. And, contrary to popular belief, long-term debt-to-equity ratios show a statistically significant negative correlation with financing through debt. Hence, the empirical findings signify Long-term debts have a detrimental impact on SMEs financial performance. Similarly, short-term debts have a detrimental impact on SMEs performance in terms of ROA and liquidity, according to the research. As a result, debt-financed both short and long-term loans have a disadvantageous impact on SMEs' financial performance (Githaiga, 2015; Maes et al., 2019).

The outcomes of the study show that debt-financed loans, both long and short term, have a negative impact on financial performance. If SMEs are evaluated essentially to advance their financial performance. This necessitates capacity building in areas such as company management

and good financial record keeping. Which should be reflected in a reduction in loan processing time and borrowing costs. With the foregoing, it is reasonable to conclude that the government will benefit greatly from encouraging SMEs through training and skill development. This would help them to better use their loans by lowering the likelihood of their being credit rationed.

SMEs in Ghana have one viable alternative to create cooperative societies, which would allow them to share their risks when asking for bank loans. Banks are more inclined to work with groups as compared to individual SMEs, who may lack the necessary expertise and financial abilities to persuade banks in gaining money. As a result, for SMEs in Ghana to solely apply it is more likely profitable for commercial bank loans when they operate together as a group. It is vital to remember that commercial banks' primary objective is to make money. Corresponding to Agyei-Mensah (2010), financial statements and additional strategic performance indicators should be generated regularly, consistent basis, and compare to previous phases for the best outcomes.

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