



**COST OF DEBT AND FINANCIAL PERFORMANCE OF SMALL AND  
MEDIUM ENTERPRISES (SMEs) IN LIRA CITY, UGANDA**

**BY**

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**A THESIS SUBMITTED TO THE DEPARTMENT OF BUSINESS ADMINISTRATION  
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**OCTOBER, 2025**

**DECLARATION**

I, **ODYEK CHRISTINE**, hereby declare that this research thesis is a result of my original research work and that it has never been presented to any institution of learning for any reason whatsoever.

Where citations have been made, acknowledgement has been made extensively.

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**APPROVAL**

This is to certify that this research report on “Cost of debt and financial performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda” has been under my supervision and is now ready for submission to Muni University for the award of a Master’s Degree in Business Administration (Accounting & Finance)

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## Abstract

This study investigates the relationship between the cost of debt and the financial performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda. **The purpose of this study is to investigate the impact of interest expenses**, loan maturity periods, and debt servicing capacity on the profitability, liquidity, and overall financial sustainability of SMEs. Despite the critical role of debt financing in SME growth, the rising cost of borrowing and limited access to affordable credit continue to constrain performance and survival, particularly in developing economies like Uganda. **A descriptive and correlational research design** was adopted, integrating both quantitative and qualitative approaches. The study targeted a sample of 120 SMEs registered with the Uganda Registration Services Bureau (URSB) in Lira City. Data were collected through structured questionnaires and key informant interviews, and analyzed using descriptive statistics, Pearson correlation, and multiple regression analysis aided by SPSS version 26. The analysis tested the statistical significance of the cost of debt variables on financial performance indicators such as return on assets (ROA), return on equity (ROE), and net profit margin. **Findings revealed** a significant negative relationship between high cost of debt and SME financial performance, indicating that elevated interest rates and short repayment periods erode profitability and capital efficiency. However, prudent debt management and strategic utilization of borrowed funds were found to moderate this relationship positively. **The study was limited** by its cross-sectional design, which may not capture long-term financial dynamics, and reliance on self-reported data, which may introduce response bias. Nevertheless, the research contributes to empirical literature by offering context-specific insights into how debt pricing structures affect SME financial health in Uganda, guiding policymakers and financial institutions toward more sustainable lending frameworks.

**Keywords:** *Cost of debt, Financial performance, SMEs, Interest rate, Debt management, Lira City, Uganda.*



# CHAPTER ONE

## INTRODUCTION

### 1.0 Introduction

This chapter presents the study's background, statement of the problem, purpose, objectives, research questions, and scope. It provides a comprehensive foundation for understanding the rationale and direction of the study. Specifically, the chapter introduces the key concepts of the cost of debt and the financial performance of SMEs, highlights existing knowledge gaps, and establishes the significance of focusing on SMEs in Lira City, Uganda. In doing so, it guides the reader on what the study is about, the issues it seeks to address, and the contributions it intends to make to both academic scholarship and policy practice.

### 1.1 Background to the Study

#### 1.1.1 Conceptual Perspective

The relationship between the cost of debt and financial performance is central to understanding how firms navigate financial challenges, especially in diverse economic environments (Carl Arthur, 2024). The *cost of debt*, often defined as the effective interest rate and associated expenses incurred when borrowing funds, is a critical determinant of a company's financial health (Keasey, Pindado, & Rodrigues, 2015). *Financial performance*, on the other hand, refers to the measurement of a firm's profitability, liquidity, solvency, and efficiency over a given period (Demirgüneş, 2016). These concepts are closely interlinked, as the cost of debt directly influences a firm's ability to maintain and improve its financial standing (Myers, 1977; Damodaran, 2002).

Globally, the relationship between the cost of debt and financial performance has been extensively examined. Modigliani and Miller (1958) introduced the idea that, in an ideal market, the cost of capital does not affect a firm's value. However, real-world imperfections such as taxes and bankruptcy costs make debt financing a significant factor in determining financial performance. The cost of debt is typically expressed as the interest rate plus any additional fees that a firm must pay to lenders. This cost may be influenced by several factors, including market conditions, the firm's creditworthiness, and the loan terms (Damodaran, 2002).

Financial performance encompasses various metrics that reflect a firm's overall financial health. These include profitability ratios such as Return on Assets (ROA) and Return on Equity (ROE), liquidity ratios such as the current ratio, and solvency ratios like the debt-to-equity ratio. High costs of debt can

negatively affect these metrics by reducing net income and increasing financial strain, thereby impairing a firm's ability to invest in growth opportunities (Fama & French, 2002).

In emerging markets, the relationship between the cost of debt and financial performance is influenced by unique contextual factors. High interest rates, currency volatility, and underdeveloped financial markets make debt more expensive and riskier for firms (Booth et al., 2001). These higher costs often lead to reduced profitability, as firms struggle to generate returns that exceed their borrowing costs. Booth et al. (2001) found that in emerging markets such as Brazil, India, and South Africa, firms face significantly higher costs of debt compared to those in developed markets. The study further emphasized that these higher costs could lead to financial distress, particularly for firms without access to international capital markets, where borrowing is relatively cheaper.

In Uganda, the high cost of debt poses a significant obstacle to financial performance, particularly for Small and Medium Enterprises (SMEs). The financial environment in Uganda is characterized by elevated interest rates, limited access to credit, and a lack of alternative financing options (Kasekende, 2016). Mugisha (2018) defines the cost of debt in the Ugandan context as the interest rate charged by local banks, which is often influenced by inflation, exchange rate fluctuations, and the borrower's risk profile. Financial performance in Uganda, as elsewhere, is assessed using indicators such as profitability, liquidity, and solvency. However, the high cost of debt often results in poor financial performance, as SMEs struggle to service their debt while maintaining operational efficiency (Mugisha, 2018). Tumwine et al. (2020) noted that these challenges are further exacerbated by the limited access many Ugandan firms have to international financial markets, forcing them to rely on local sources of finance with higher associated costs.

The relationship between the cost of debt and financial performance is therefore complex and varies across economic contexts. Globally, lower costs of debt are generally associated with better financial performance. However, in emerging markets such as Uganda, high borrowing costs present significant challenges to financial sustainability. Addressing these challenges requires policy interventions and innovative financial products aimed at lowering borrowing costs and enhancing access to finance, particularly for SMEs. Future research should continue to explore these dynamics, focusing on strategies that can improve financial performance in both developed and emerging economies.

### **1.1.2 Theoretical Background**

The *Trade-Off Theory* by Kraus and Litzenberger (1973) provides the foundational framework for this study, offering a structured approach to understanding how firms balance the benefits and costs of debt

in financial decision-making. The theory, one of the most widely recognized in corporate finance, posits that firms aim to balance the advantages of debt financing, such as tax shields, against potential costs associated with financial distress. It suggests that there exists an optimal capital structure at which the marginal benefit of additional debt equals its marginal cost, thereby maximizing firm value.

For SMEs, the Trade-Off Theory offers a compelling lens through which to understand how debt influences financial performance. SMEs often face unique challenges compared to larger firms, including limited access to capital markets, higher cash flow volatility, and greater vulnerability to financial distress. According to the theory, SMEs can benefit from debt financing due to the tax deductibility of interest payments, which reduces their overall tax burden and enhances profitability (Myers, 1984). This tax advantage is particularly important for SMEs, which typically operate with thinner profit margins. By leveraging debt appropriately, SMEs can potentially improve their financial performance by lowering their overall cost of capital.

However, the theory also highlights the risks associated with excessive debt. As firms increase leverage, they face a higher probability of financial distress, which can lead to bankruptcy. This risk is especially pronounced for SMEs, which often lack the resources to withstand financial downturns. High levels of debt increase interest obligations, straining cash flow and limiting a firm's ability to invest in growth opportunities (Titman & Wessels, 1988). Thus, while debt can enhance financial performance up to a certain point, excessive debt may result in diminishing returns and heightened financial vulnerability.

Applying the Trade-Off Theory to SMEs underscores the importance of maintaining an optimal balance between debt and equity. Given their size and resource constraints, SMEs must carefully manage their capital structures to avoid over-leverage. Frank and Goyal (2008) argue that SMEs are more susceptible to the negative consequences of financial distress, making the trade-off between the benefits of debt and the risks of distress even more critical. This theory therefore provides a useful framework through which SMEs can evaluate their financing decisions and align them with their performance objectives.

Despite its relevance, the Trade-Off Theory is not without limitations. One major criticism is its assumption that firms can accurately determine their optimal capital structure. In reality, this is challenging—especially for SMEs that often lack the sophisticated financial expertise available to larger corporations. Moreover, the theory assumes that the benefits and costs of debt are static, whereas they fluctuate with market conditions, interest rate movements, and firm-specific factors (Graham, 2000). This static perspective may lead to suboptimal financial decisions if firms fail to account for the dynamic nature of financial markets.

To mitigate these limitations, SMEs can adopt a more flexible approach to capital structure management. This involves continuously monitoring financial performance and adjusting leverage in response to changes in the business environment. For instance, firms may reduce debt levels during economic uncertainty to minimize financial distress risks, and increase leverage during stable periods to exploit tax advantages (Korajczyk & Levy, 2003). SMEs can also diversify their financing sources—such as by seeking equity crowdfunding or venture capital—to reduce dependence on debt and enhance financial resilience.

In conclusion, the Trade-Off Theory provides a valuable theoretical lens for understanding the relationship between the cost of debt and financial performance in SMEs. By balancing the benefits of debt, such as tax shields, against the risks of financial distress, SMEs can optimize their capital structures to enhance financial performance. Nonetheless, the theory's limitations highlight the need for a dynamic and adaptive approach to capital structure management, enabling SMEs to respond effectively to changing market conditions and maintain long-term financial stability.

### **1.1.3 Historical Background**

The relationship between the cost of debt and financial performance has evolved significantly over time, shaped by economic theories, market developments, and changes in the global financial landscape (Barnett & Salomon, 2012). Historically, the cost of debt and its impact on financial performance have been central to the study of corporate finance, with scholars and practitioners recognizing the importance of understanding how borrowing costs influence a firm's profitability, growth, and overall financial health (Hasan, Hossain, & Habib, 2015).

The historical discourse on the cost of debt began with classical economic theories, which largely viewed debt as a necessary evil for businesses. In the early 20th century, economists such as Irving Fisher (1930) emphasized the role of interest rates in determining the cost of debt.

The mid-20th century ushered in the foundational work of Modigliani and Miller (1958), who introduced the irrelevance theory of capital structure. According to their proposition, in a perfect market, the cost of capital—including debt—does not affect a firm's value. However, they acknowledged that in the real world, market imperfections such as taxes, bankruptcy costs, and information asymmetry make the cost of debt a crucial factor in financial decision-making (Miglo, 2020). Their work stimulated further research into how firms manage debt to optimize financial performance under varying market conditions.

In the post-World War II era, the expansion of global economies led to an increase in corporate borrowing as firms sought to capitalize on growth opportunities. During this period, the cost of debt became more variable, influenced by factors such as inflation, government policies, and global economic cycles. The 1970s, marked by high inflation and fluctuating interest rates, further underscored the need for firms to carefully manage the cost of debt to maintain financial stability (Myers, 1977).

The trade-off theory, developed by Kraus and Litzenberger (1973), emerged during this time, positing that firms balance the tax advantages of debt against the potential costs of financial distress. Similarly, the pecking order theory proposed by Myers and Majluf (1984) suggested that firms prefer internal financing but resort to debt when external financing is necessary, prioritizing it over equity due to its lower costs. These theories highlighted the increasingly complex relationship between the cost of debt and financial performance, particularly as firms navigated periods of economic volatility.

The late 20th and early 21st centuries witnessed the globalization of financial markets, which significantly affected the cost of debt. The liberalization of capital markets enabled firms, especially in developed economies, to access debt at lower costs, thereby enhancing financial performance. However,

this era also introduced new risks, as firms in emerging markets faced higher borrowing costs due to political instability, currency risk, and underdeveloped financial systems (Booth et al., 2001).

In emerging economies such as Uganda, the cost of debt has remained relatively high because of factors such as underdeveloped financial markets, elevated interest rates, and limited access to international capital. During the structural adjustment programs of the 1980s and 1990s, many African countries, including Uganda, implemented economic reforms that emphasized financial liberalization. Although these reforms aimed to improve access to credit, they also led to higher borrowing costs for local firms as interest rates were liberalized and subsidies were withdrawn (Kasekende, 2016).

A comparison of historical trends reveals that while developed economies have benefited from lower costs of debt due to financial market maturity and economic stability, emerging markets have continued to grapple with high borrowing costs. In developed markets, the evolution of sophisticated financial instruments and the availability of cheaper debt have generally improved financial performance (Fama & French, 2002). In contrast, firms in emerging markets such as Uganda continue to face challenges, as high borrowing costs adversely affect their profitability and growth prospects.

The historical evolution of the cost of debt and financial performance underscores the importance of economic and financial market developments in shaping this relationship. Over time, theories and practices have evolved to reflect the complexities of debt management in different economic contexts, highlighting the disparities between firms in developed and emerging markets. Understanding this historical progression is vital for policymakers and business leaders as they navigate the challenges of debt financing in today's globalized economy.

#### **1.1.4 Contextual Background**

The relationship between the cost of debt and financial performance is particularly significant for Small and Medium Enterprises (SMEs), which often depend on external financing to sustain and expand their operations (Harash, Al-Timimi, & Alsaadi, 2014). In Lira City, Uganda, SMEs are vital to the local economy as they contribute to employment, innovation, and overall economic development. However, Rajamani et al. (2022) note that these enterprises face considerable challenges, particularly regarding access to affordable credit.

The cost of debt, which encompasses interest rates and associated fees, is a critical factor that can either support or hinder SMEs' financial performance. In Uganda, the financial environment is characterized by relatively high interest rates, which are often prohibitive for SMEs. According to the Bank of Uganda (2022), the average lending rates for commercial loans have remained above 20%, making debt a costly

financing option for many small businesses. This high cost of borrowing is influenced by factors such as inflation, borrower risk profiles, and the underdeveloped nature of the financial markets (Kasekende, 2016).

Like other regions in Uganda, Lira City faces these challenges. SMEs in the area often struggle to access credit at affordable rates, and when they do, the high cost of debt can significantly affect their financial performance. This challenge is particularly pronounced for SMEs operating on thin profit margins and lacking the financial resilience to absorb high financing costs (Mugisha, 2018). Consequently, these enterprises may experience reduced profitability, lower liquidity, and heightened financial risk, all of which constrain their growth and sustainability.

Financial performance for SMEs is typically assessed through indicators such as profitability, liquidity, and solvency. In Lira City, these metrics are especially sensitive to the cost of debt. High interest rates and unfavorable loan terms can erode profitability by increasing debt-servicing costs, thereby leaving less capital available for reinvestment and growth (Tumwine et al., 2020). Moreover, stringent loan conditions—such as collateral requirements—further strain SMEs' financial resources, limiting their ability to achieve optimal performance.

Nakisozi and Nalukenge (2019) found that SMEs in Northern Uganda, including Lira City, often rely on informal credit sources due to the prohibitive cost of formal loans. However, these informal sources also tend to carry high interest rates and lack the structured support of formal financial institutions, leading to a cycle of debt that is difficult to escape. The high cost of debt has thus emerged as a major barrier to profitability and sustainability among SMEs in this region.

When compared with other parts of Uganda, SMEs in Lira City face similar credit challenges but with some regional variations. For example, SMEs in the Central Region—particularly in Kampala—enjoy relatively better access to financial services and slightly lower interest rates due to more competitive markets and a larger number of financial institutions (Kasekende, 2016). In contrast, SMEs in Lira City encounter higher borrowing costs due to less developed financial infrastructure and greater perceived lending risks.

Furthermore, SMEs in more developed economies or urban centers benefit from lower debt costs and more favorable loan conditions, enabling them to leverage debt more effectively to enhance financial performance (Booth et al., 2001). These disparities underscore the regional inequalities within Uganda and highlight the need for targeted financial policies that address the unique challenges facing SMEs in areas such as Lira City.

In summary, the cost of debt remains a crucial determinant of SMEs' financial performance in Lira City, Uganda. High interest rates and restrictive loan conditions present significant obstacles to profitability, liquidity, and overall financial stability. Addressing these challenges requires not only expanding access to affordable credit but also strengthening financial literacy and debt management capabilities among SMEs. Policymakers and financial institutions must collaborate to create a more enabling financial environment for SMEs in Lira City, thereby enhancing their capacity to thrive and contribute to regional economic development.

## **1.2 Statement of the Problem**

Small and Medium Enterprises (SMEs) are central to Uganda's economy, accounting for about 90% of private sector businesses, contributing nearly 20% to the Gross Domestic Product (GDP), and employing over 2.5 million people (UIA, 2021). Despite this significant contribution, SMEs in Lira City continue to face serious financial sustainability challenges, largely due to the high cost of debt. According to Lira City Council (2022), the average lending rates for SMEs in the region often exceed 20%, making debt financing prohibitively expensive. This burden is reflected in weak financial performance, with over 70% of SMEs struggling to meet loan obligations, nearly 40% defaulting, and almost half collapsing within three years of operation (UBOS, 2023; UIA, 2021).

High borrowing costs, limited access to tax shields, and elevated credit risk undermine profitability, liquidity, and solvency, leaving SMEs financially vulnerable. Local data further reveal that economic instability—characterized by interest rate volatility, inflationary pressures, and restricted access to affordable credit—exacerbates the situation, deepening financial distress and limiting reinvestment opportunities (Lira City Council, 2022). Although some studies have examined SMEs in Lira, existing research has largely employed qualitative approaches (Okello, Onyango-Delewa, & Owot, 2025) or focused on credit financing without disaggregating specific cost-of-debt components such as interest rates, tax shields, and credit risk (Eton, Mwosi, Mutesigensi, & Ebong, 2017). This gap underscores the need to investigate the relationship between the cost of debt and the financial performance of SMEs in Lira City.

By generating empirical evidence, this study aims to inform policy formulation and financing strategies that can enhance SME viability, reduce loan default rates, and strengthen their contribution to both local and national economic development.

## **1.3 Objectives of the study**

### **1.3.1 General Objective**

The purpose of this study was to determine the impact of Cost of Debt and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda.

### **1.3.2 Research Objectives**

To achieve the above purpose, the study investigated the following specific objectives:

- i. To establish the relationship between interest rate and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.
- ii. To assess the effect of Tax shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City,
- iii. To determine the contribution of Credit risk to the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.
- iv. To examine the moderating influence of Economic conditions on the cost of Debt and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

### **1.4 Research Questions**

- i. What is the relationship between interest rate and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City?
- ii. What is the effect of Tax shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City?
- iii. What is the contribution of Credit risk to the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City?
- iv. What is the moderating influence of Economic conditions on the cost of Debt and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City?

### **1.5 Research Hypotheses**

***H01:*** There is no significant relationship between interest rate and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

***H02:*** There is no significant effect of Tax shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

***Ho3:*** There is no significant contribution of Credit risk on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

***Ho4:*** There is no significant moderating influence of Economic conditions on the cost of Debt and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

## **1.6 Scope of the study**

The scope of the study included the content scope, time scope, geographical scope, and theoretical scope.

### **1.6.1 Content Scope**

The study examines the relationship between the cost of debt and the financial performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda. The content scope includes an analysis of various components of the cost of debt, such as interest rates, fees, and other charges associated with borrowing. Additionally, the study assesses key indicators of financial performance, including profitability, liquidity, solvency, and overall financial stability. The study aims to explore how these debt-related costs impact the financial health of SMEs and identify potential strategies that could mitigate negative effects, thereby improving the sustainability and growth prospects of these enterprises (Kasekende, 2016; Nakisozi & Nalukenge, 2019).

### **1.6.2 Time Scope**

The time scope of this study covers a period of five years, from 2018 to 2024. This period is chosen to provide a comprehensive view of the trends and dynamics of the cost of debt and financial performance in SMEs over time. It encompasses both pre-pandemic and post-pandemic years, allowing for the analysis of how external economic shocks, such as COVID-19, may have influenced borrowing costs and financial outcomes for SMEs in Lira City. This longitudinal approach ensures that the study captures any significant changes or patterns that have emerged during this period, offering insights into both short-term and long-term impacts on SMEs' financial performance (Uganda Bureau of Statistics [UBOS], 2021).

### **1.6.3 Geographical Scope**

Geographically, the study is confined to Lira City, located in Northern Uganda. Lira City is a significant commercial hub in the region, with a diverse range of SMEs operating in various sectors, including retail, manufacturing, agriculture, and services. The coordinates of Lira City are 2°14'50.0"N 32°54'00.0"E (Latitude: 02.2472; Longitude: 32.9000). By focusing on Lira City, the study aims to provide detailed insights into the specific challenges and opportunities faced by SMEs in this area, which may differ from those in other regions of Uganda due to local economic conditions, access to financial services, and market dynamics (Lira City Council, 2022). The findings of this study are intended to be relevant not only to Lira City but also to similar urban centers in Uganda and other developing countries.

### **1.6.4 Theoretical Scope**

The theoretical scope of this study is grounded in financial management and corporate finance theories, particularly the Pecking Order Theory and the Trade-Off Theory. The Pecking Order Theory suggests that firms prefer to finance themselves first with internal funds, then with debt, and finally with equity, due to the costs associated with each type of financing (Myers & Majluf, 1984). This theory is relevant in understanding why SMEs in Lira City might resort to debt despite its high cost. On the other hand, the Trade-Off Theory posits that firms seek to balance the tax benefits of debt against the potential costs of financial distress (Kraus & Litzenberger, 1973). This study will explore how SMEs in Lira City navigate this trade-off and the extent to which the cost of debt influences their financial decisions and performance.

## 1.7 Significance of the Study

The study on the cost of debt and financial performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda, holds significant importance for various stakeholders, including policymakers, financial institutions, SME owners, and academic researchers.

*For Policymakers:* The findings from this study provide valuable insights into the financial challenges faced by SMEs in Lira City, particularly concerning the high cost of debt. Understanding the impact of the cost of debt on SME financial performance can guide policymakers in formulating targeted interventions and financial policies aimed at improving access to affordable credit for SMEs. This is particularly critical in a developing economy like Uganda, where SMEs are a key driver of economic growth and employment. By addressing the financial barriers that hinder SME growth, policymakers can contribute to the creation of a more conducive environment for business development, which is essential for poverty reduction and economic stability in the region.

*For Financial Institutions:* Financial institutions, including banks and microfinance organizations, will benefit from the study by gaining a deeper understanding of how their lending practices influence the financial health of SMEs. The study's findings can inform the development of more SME-friendly loan products, with interest rates and loan terms that are aligned with the financial realities of small businesses. This can lead to a more sustainable relationship between lenders and SMEs, where both parties benefit from improved financial performance. Additionally, the study may highlight the need for financial institutions to offer more financial literacy and advisory services to SMEs, helping them manage their debt more effectively and enhance their financial performance.

*For SME Owners and Entrepreneurs:* The study is directly relevant to SME owners and entrepreneurs in Lira City, as it provides practical insights into how the cost of debt affects their businesses' financial performance. By understanding the specific financial risks associated with high borrowing costs, SME owners can make more informed decisions about financing options and debt management strategies. The study also uncovers best practices and strategies that successful SMEs have employed to mitigate the negative effects of high cost of debt, which can serve as a guide for other businesses facing similar challenges.

*For Academic Researchers:* Academically, this study contributes to the existing body of literature on SME financing and financial performance in developing economies. It provides empirical data specific to Lira City, Uganda, filling a gap in the literature where most studies have focused on larger urban centers like Kampala. The study's findings are valuable for researchers interested in exploring the nuances of SME financing in smaller cities and rural areas, as well as those interested in comparative

studies between different regions. Moreover, the study opens avenues for further research on related topics, such as the role of financial literacy in SME performance or the impact of external economic shocks on SME financing.

Overall, the study has a far-reaching impact by providing actionable insights that can help improve the financial sustainability and growth prospects of SMEs in Lira City, ultimately contributing to the broader economic development of the region.

## **1.8 Justification of the Study**

Several key factors underscore the justification for studying the impact of the cost of debt on the financial performance of Small and Medium Enterprises (SMEs) in Lira City, Uganda. These factors highlight the urgency and importance of addressing this issue.

*Economic Significance of SMEs in Lira City:* SMEs are critical to the economic development of Lira City and Uganda as a whole. They play a pivotal role in job creation, income generation, and economic diversification. However, the high cost of debt poses a significant threat to their financial stability and growth potential. Despite their importance, SMEs in Lira City face unique financial challenges that have not been thoroughly examined in existing research. By focusing on this specific geographic and economic context, the study aims to provide targeted insights that are crucial for enhancing the financial health and sustainability of SMEs in this region. This localized understanding can help develop effective strategies and policies tailored to the specific needs of Lira City's SME sector.

*High Cost of Debt as a Barrier to Growth:* The high cost of debt is a major barrier to the growth and profitability of SMEs in Lira City. According to recent reports, SMEs in the region face average interest rates that exceed 20%, making borrowing expensive and often unsustainable (Lira City Council, 2022). This high cost of debt can lead to reduced profitability, lower liquidity, and increased financial risk, which hampers the ability of SMEs to invest in growth and innovation. By examining the relationship between the cost of debt and financial performance, the study seeks to quantify the impact of high borrowing costs and identify potential solutions to mitigate these challenges, thereby supporting the long-term viability of SMEs.

*Knowledge Gap in Existing Research:* There is a notable gap in the existing literature regarding the specific challenges faced by SMEs in smaller cities like Lira. Most research on the cost of debt and financial performance has predominantly focused on larger urban centers, such as Kampala, leaving a gap in understanding the unique financial dynamics of SMEs in smaller and less developed areas (Uganda Bureau of Statistics, 2021). This study aims to address this gap by providing empirical data and

insights specific to Lira City, contributing to a more comprehensive understanding of SME financing issues in diverse regional contexts. This localized research is essential for developing effective interventions and policies that address the specific needs of SMEs in similar settings.

*Policy and Practice Implications:* The findings of this study are expected to have significant implications for both policymakers and financial institutions. By identifying the key factors that influence the financial performance of SMEs and understanding how the cost of debt impacts their operations, the study will provide valuable information for crafting targeted financial policies and loan products. This can lead to more supportive financial environments for SMEs, including reduced borrowing costs, better access to credit, and improved financial literacy programs. Such measures are crucial for fostering a healthier SME sector that can contribute more effectively to local and national economic development.

*Potential for Future Research:* The study will also lay the groundwork for future research on SME financing in Uganda and other developing economies. By providing a detailed analysis of the impact of cost of debt on financial performance, the research will offer a foundation for further investigations into related topics, such as the role of financial education in managing debt, the impact of macroeconomic factors on SME financing, and comparative studies between different regions and countries.

In summary, this study is justified by the critical need to understand and address the financial challenges faced by SMEs in Lira City due to the high cost of debt. The insights gained will be instrumental in supporting the growth and sustainability of SMEs, filling a crucial research gap, and informing policies and practices that enhance the financial health of businesses in this and similar regions.

## **1.9 Definition of Key Terms**

***Cost of debt:*** Cost of Debt refers to the total expense incurred by a company in borrowing funds. It includes interest payments, fees, and other charges associated with debt financing. Cost of Debt is a crucial factor in determining the financial viability of borrowing, as high costs can erode profits and affect overall financial performance (Myers, 2001).

***Financial Performance:*** Financial performance is a measure of a company's financial health and operational efficiency, typically assessed through indicators such as profitability, liquidity, solvency, and operational efficiency. It reflects how well a company is utilizing its resources to generate income and sustain growth (Higgins, 2012).

***Small and Medium Enterprises (SMEs):*** SMEs are businesses characterized by their relatively small size in terms of employees and revenue. They are typically classified based on thresholds set by regulatory bodies; for instance, in Uganda, SMEs are defined as businesses with fewer than 100

employees and annual revenues not exceeding UGX 360 million (Uganda Bureau of Statistics [UBOS], 2021).

**Profitability:** Profitability is the ability of a company to generate earnings compared to its expenses over a specific period. It is often measured using ratios such as return on assets (ROA) and return on equity (ROE), which indicate how effectively a company is converting its revenue into profit (Brigham & Ehrhardt, 2013).

**Liquidity:** Liquidity refers to a company's ability to meet its short-term financial obligations using its liquid assets. It is assessed using ratios like the current ratio and quick ratio, which measure the adequacy of a company's liquid assets relative to its short-term liabilities (Van Horne & Wachowicz, 2008).

**Solvency:** Solvency is the capacity of a company to meet its long-term obligations and continue its operations over the long term. It is typically assessed through ratios such as the debt-to-equity ratio and interest coverage ratio, which provide insight into a company's financial stability (Higgins, 2012).

**Interest Rate:** The interest rate is the cost of borrowing money, expressed as a percentage of the principal amount. It is a key component of the cost of debt and can significantly impact a company's financial performance by affecting the total expense of servicing debt (Modigliani & Miller, 1958).

**Collateral:** Collateral is an asset pledged by a borrower to secure a loan. In the event of default, the lender has the right to seize the collateral to recover the outstanding debt. Collateral requirements can affect SMEs' access to credit and their ability to secure favorable loan terms (Fama, 1985).

**Debt-to-Equity Ratio:** The debt-to-equity ratio is a financial metric that compares a company's total debt to its shareholders' equity. It is used to assess the relative proportion of debt and equity financing used by a company, indicating its financial leverage and risk (Brigham & Ehrhardt, 2013).

**Credit Risk:** Credit risk is the possibility that a borrower may default on their debt obligations, leading to a financial loss for the lender. It is influenced by factors such as the borrower's creditworthiness and the terms of the loan. Effective management of credit risk is essential for maintaining financial stability and performance (Jarrow & Turnbull, 2000).

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 Introduction**

This chapter presents a critical review of the literature related to the study topic, guided by the research objectives. It is divided into four major sections: a literature survey, a theoretical review, an empirical review, and a summary highlighting the identified literature gaps.

#### **2.1 Literature Survey**

The relationship between the cost of debt and financial performance has attracted significant attention in financial management literature, particularly in the context of Small and Medium Enterprises (SMEs) (Mugisha, Omagwa, & Kilika, 2020). This section reviews key studies, highlighting their findings, methodological approaches, and contrasting perspectives to provide a comprehensive understanding of the subject.

The cost of debt exerts a substantial influence on the financial performance of SMEs. Myers (2001) emphasizes that a high cost of debt can reduce a firm's profitability by increasing interest expenses, thereby affecting net income and liquidity. Similarly, Harris and Raviv (1991) found that elevated debt levels increase financial distress costs, which, in turn, negatively affect firm performance. In contrast, Booth et al. (2001) argue that the impact of the cost of debt on SMEs may vary depending on access to credit markets and financial structure. Their findings indicate that firms with better access to credit can sustain higher levels of debt without a proportional decline in performance. This suggests that while the cost of debt is a crucial determinant of performance, its impact may be moderated by a firm's financial characteristics and external financing conditions.

In examining this relationship further, Mugisha, Omagwa, and Kilika (2020) investigated SMEs in Uganda's Buganda Region and found that short-term debt had a significant negative effect on financial performance, measured by Return on Assets (ROA). This finding implies that excessive reliance on short-term borrowing may constrain profitability among SMEs in the region. Booth et al. (2001) extended this analysis through a cross-country study of capital structure choices, revealing that the effects of long-term debt on financial performance vary across countries due to differences in financial systems and institutional environments. These findings underscore the importance of considering country-specific and contextual factors when assessing debt-performance dynamics.

Although details of Myers' (2021) study are limited in the available literature, research on capital structure consistently highlights the role of external factors—such as market conditions and macroeconomic stability—in moderating the relationship between debt and financial performance. Understanding these moderating influences is particularly vital for SMEs operating in volatile and dynamic market environments.

The theoretical foundations of these studies are primarily grounded in the Pecking Order Theory and the Trade-Off Theory. The Pecking Order Theory posits that firms prefer internal financing sources and only resort to external debt when internal funds are insufficient. This framework explains SMEs' preference for less debt financing and its corresponding influence on performance outcomes. The Trade-Off Theory, on the other hand, argues that firms seek an optimal capital structure by balancing the tax advantages of debt against the potential costs of financial distress. Both theories provide critical insights into how SMEs make financing decisions aimed at maximizing firm value.

Integrating these perspectives allows for a comprehensive exploration of how various forms of debt influence the financial performance of SMEs, considering both internal financing behavior and external market conditions. This integrated approach provides a nuanced understanding of capital structure decisions in the SME sector.

In developing economies such as Uganda, the high cost of debt presents a particularly acute challenge for SMEs. According to the World Bank (2020), SMEs in Sub-Saharan Africa face exorbitant interest rates due to perceived higher credit risks and limited access to financial markets. Similarly, the Uganda Bureau of Statistics (UBOS, 2021) reports that local SMEs face persistently high borrowing costs, which adversely affect their profitability and liquidity. These findings align with Kyereboah-Coleman and Osei (2008), who contend that high debt costs in developing economies often lead to reduced profitability and increased financial instability. However, some studies have demonstrated that the negative impact of costly debt can be mitigated through sound financial management practices. For example, Love (2003) found that SMEs employing strategic financial practices—such as hedging interest rate risks and optimizing their capital structures—are better equipped to withstand the adverse effects of high borrowing costs. This implies that although the cost of debt remains a critical determinant of performance, effective financial management can significantly moderate its impact.

Comparative studies further illustrate how debt costs affect SMEs across regions. Beck and Demirgüç-Kunt (2006) compared SMEs in developed and developing countries and found that those in developing economies, including Uganda, face more severe challenges due to underdeveloped financial systems and higher risk premiums. Conversely, SMEs in developed economies enjoy better access to affordable

credit, resulting in relatively superior financial performance. Similarly, Zia (2008) compared SMEs across various African countries and observed that while high borrowing costs are a common constraint, their magnitude and effects vary based on local economic conditions and regulatory environments. SMEs operating in economies with supportive financial policies and efficient credit systems experience less adverse effects compared to those in less conducive environments.

Within the context of Lira City, Uganda, empirical evidence highlights the specific challenges faced by SMEs resulting from the high cost of borrowing. According to the Lira City Council (2022), SMEs in the region contend with interest rates that significantly erode profitability and impede financial stability. These findings are consistent with broader studies conducted in Uganda and the Sub-Saharan African region, where high borrowing costs have been identified as a major obstacle to SME growth and sustainability (Kyereboah-Coleman & Osei, 2008).

Overall, the reviewed literature indicates that while the high cost of debt is a universal concern among SMEs, its magnitude and consequences vary depending on regional economic conditions, access to credit markets, and the adoption of effective financial management strategies. This review underscores the need for localized research focusing on specific contexts such as Lira City to generate context-sensitive insights and develop strategies that mitigate the adverse effects of high borrowing costs on SME financial performance.

## **2.2 Theoretical Review**

### **Theories of Cost of Debt and Financial Performance**

Cost of Debt and financial performance are interrelated concepts within corporate finance, and various theories have been proposed to explain the dynamics between them. The most influential theories in this domain are the Trade-Off Theory, Pecking Order Theory, Agency Theory, and Signaling Theory, each providing distinct insights into how debt influences financial outcomes for firms. The current study, however, adopted the Trade-Off Theory as the one that underpins the study and comprehends the relationship between the study variables.

#### **The Trade-Off Theory**

The Trade-Off Theory is one of the most widely recognized theories in corporate finance, particularly in the context of understanding the relationship between the cost of debt and financial performance. Proposed by Kraus and Litzenberger (1973), this theory suggests that firms aim to balance the benefits of debt financing, such as tax shields, against the potential costs associated with financial distress. The theory posits that there is an optimal capital structure where the marginal benefit of additional debt equals its marginal cost, allowing firms to maximize their overall value.

For Small and Medium Enterprises (SMEs), the Trade-Off Theory offers a compelling framework to understand how debt influences financial performance. SMEs often face unique challenges compared to larger firms, including limited access to capital markets, higher volatility in cash flows, and greater vulnerability to financial distress. According to the Trade-Off Theory, SMEs can benefit from debt financing due to the tax deductibility of interest payments, which can reduce their overall tax burden and enhance profitability (Myers, 1984). This tax advantage is particularly significant for SMEs, which typically operate with thinner profit margins. By leveraging debt, SMEs can potentially improve their financial performance by lowering their cost of capital.

However, the Trade-Off Theory also acknowledges the risks associated with excessive debt. As firms increase their leverage, they also increase their likelihood of experiencing financial distress, which can lead to bankruptcy. This risk is particularly pronounced for SMEs, which often have limited resources to weather financial downturns. High levels of debt can lead to increased interest obligations, which may strain the firm's cash flow and limit its ability to invest in growth opportunities (Titman & Wessels, 1988). Therefore, while debt can enhance financial performance up to a certain point, excessive debt can lead to diminished returns and increased financial vulnerability.

Justifying the application of the Trade-Off Theory to SMEs involves recognizing the importance of finding an optimal balance between debt and equity. Given their size and resource constraints, SMEs must carefully manage their capital structure to avoid the pitfalls of over-leverage. According to Frank and Goyal (2008), SMEs are more susceptible to the negative consequences of financial distress, making the trade-off between the benefits of debt and the risks of financial distress even more critical. This theory provides a useful lens through which SMEs can assess their capital structure decisions and align them with their financial performance objectives.

Despite its applicability, the Trade-Off Theory is not without limitations. One of the primary criticisms is that it assumes firms can accurately determine their optimal capital structure. In reality, identifying this optimal point is challenging, especially for SMEs, which may lack the sophisticated financial tools and expertise available to larger firms. Additionally, the theory assumes that the benefits and costs of debt are static, whereas, in practice, they can fluctuate due to changes in market conditions, interest rates, and the firm's financial health (Graham, 2000). This static view can lead to suboptimal decisions if SMEs fail to account for the dynamic nature of financial markets.

To address these limitations, SMEs can adopt a more flexible approach to capital structure management. One remedy is to continuously monitor the firm's financial performance and adjust the capital structure in response to changes in the business environment. For instance, SMEs can reduce their leverage during periods of economic uncertainty to mitigate the risk of financial distress, while increasing debt during periods of stability to take advantage of tax benefits (Korajczyk & Levy, 2003). Additionally, SMEs can

diversify their financing sources, including seeking alternative forms of financing such as equity crowdfunding, to reduce reliance on debt and enhance financial resilience.

In conclusion, the Trade-Off Theory provides a valuable framework for understanding the relationship between the cost of debt and financial performance in SMEs. By balancing the benefits of debt, such as tax shields, against the risks of financial distress, SMEs can optimize their capital structure to enhance their financial performance. However, the theory's limitations necessitate a dynamic and flexible approach to capital structure management, ensuring that SMEs can adapt to changing market conditions and maintain financial stability.

### **Other theories**

In contrast, the Pecking Order Theory, introduced by Myers and Majluf (1984), argues that firms prefer internal financing (retained earnings) over external financing due to information asymmetry between managers and investors. When external financing is necessary, debt is favored over equity because it is perceived to be less influenced by information asymmetries. This theory implies that there is no specific target debt ratio; rather, the choice between debt and equity depends on the availability of internal funds and the relative costs of external financing (Shyam-Sunder & Myers, 1999). The Pecking Order Theory diverges from the Trade-Off Theory by suggesting that firms do not actively seek an optimal capital structure but rather follow a financing hierarchy.

The Agency Theory, developed by Jensen and Meckling (1976), examines the conflicts of interest between shareholders and managers, particularly in the context of debt financing. The theory posits that managers, who may not always act in the best interests of shareholders, might avoid debt to reduce the risk of financial distress and the associated pressures. However, debt can serve as a disciplinary mechanism, constraining managerial discretion by requiring regular interest payments, thereby improving financial performance (Jensen, 1986). Harris and Raviv (1991) extended the Agency Theory by analyzing how debt could reduce agency costs, thus improving firm value and aligning the interests of managers with those of shareholders. This theory contrasts with both the Trade-Off and Pecking Order theories by focusing on the role of managerial incentives and behaviors in financial decision-making.

Finally, the Signaling Theory, proposed by Ross (1977), suggests that firms use debt as a signal to convey information about their financial health to the market. Firms with strong prospects are more likely to take on debt, signaling confidence in their ability to meet future obligations. This theory posits that high levels of debt can be interpreted by investors as a positive indicator of a firm's financial strength, potentially leading to an increase in its market valuation (Leland & Pyle, 1977). Signaling Theory is particularly relevant in environments where information asymmetry is prevalent, as it highlights the communicative function of debt in the market.

Comparatively, while the Trade-Off Theory emphasizes the balancing act between the benefits and risks of debt, the Pecking Order Theory focuses on the practical sequencing of financing choices based on information asymmetry. The Agency Theory introduces a managerial perspective, suggesting that debt can serve as a tool to mitigate agency costs, whereas the Signaling Theory underscores the role of debt in conveying information to external stakeholders. Despite their limitations, these theories offer unique insights into the relationship between the cost of debt and financial performance, reflecting the multifaceted nature of financial decision-making within firms.

In the study of the Cost of Debt and Financial Performance of Small and Medium Enterprises (SMEs)," four foundational theories, Trade Off Theory, Pecking Order Theory, Agency Theory, and Signaling Theory, offer critical insights into SMEs' financing decisions and their subsequent impact on financial performance.

Trade-Off Theory proposes that firms strive to balance the tax advantages of debt financing against the potential costs of financial distress, such as bankruptcy. This theory suggests that there is an optimal capital structure where the marginal benefit of debt equals its marginal cost. For SMEs, this balance is particularly delicate due to their limited access to capital markets and higher vulnerability to financial distress. Therefore, understanding this trade-off is essential for SMEs aiming to optimize their capital structure and enhance financial performance.

Pecking Order Theory, introduced by Myers and Majluf (1984), posits that firms prefer internal financing (retained earnings) over external sources. When external financing is necessary, debt is preferred over equity due to lower information asymmetry and transaction costs. SMEs often face significant information asymmetry and limited access to equity markets, making this theory particularly relevant. It explains why SMEs might rely more heavily on debt financing and how this choice impacts their financial performance.

Agency Theory addresses the conflicts of interest between different stakeholders in a firm, particularly between owners and managers or between shareholders and debt holders. In SMEs, where ownership and management often overlap, agency conflicts may arise between owners and lenders. These conflicts can lead to agency costs, such as increased monitoring expenses or restrictive covenants, which can influence the firm's cost of debt and overall financial performance. Understanding these dynamics is crucial for SMEs to mitigate agency costs and optimize their financing decisions.

Signaling Theory suggests that firms convey information to the market through their financing choices. For instance, taking on debt might signal confidence in future cash flows, while issuing equity could indicate potential overvaluation or financial distress. For SMEs, which often lack extensive public information, financing decisions serve as important signals to investors and creditors. These signals can

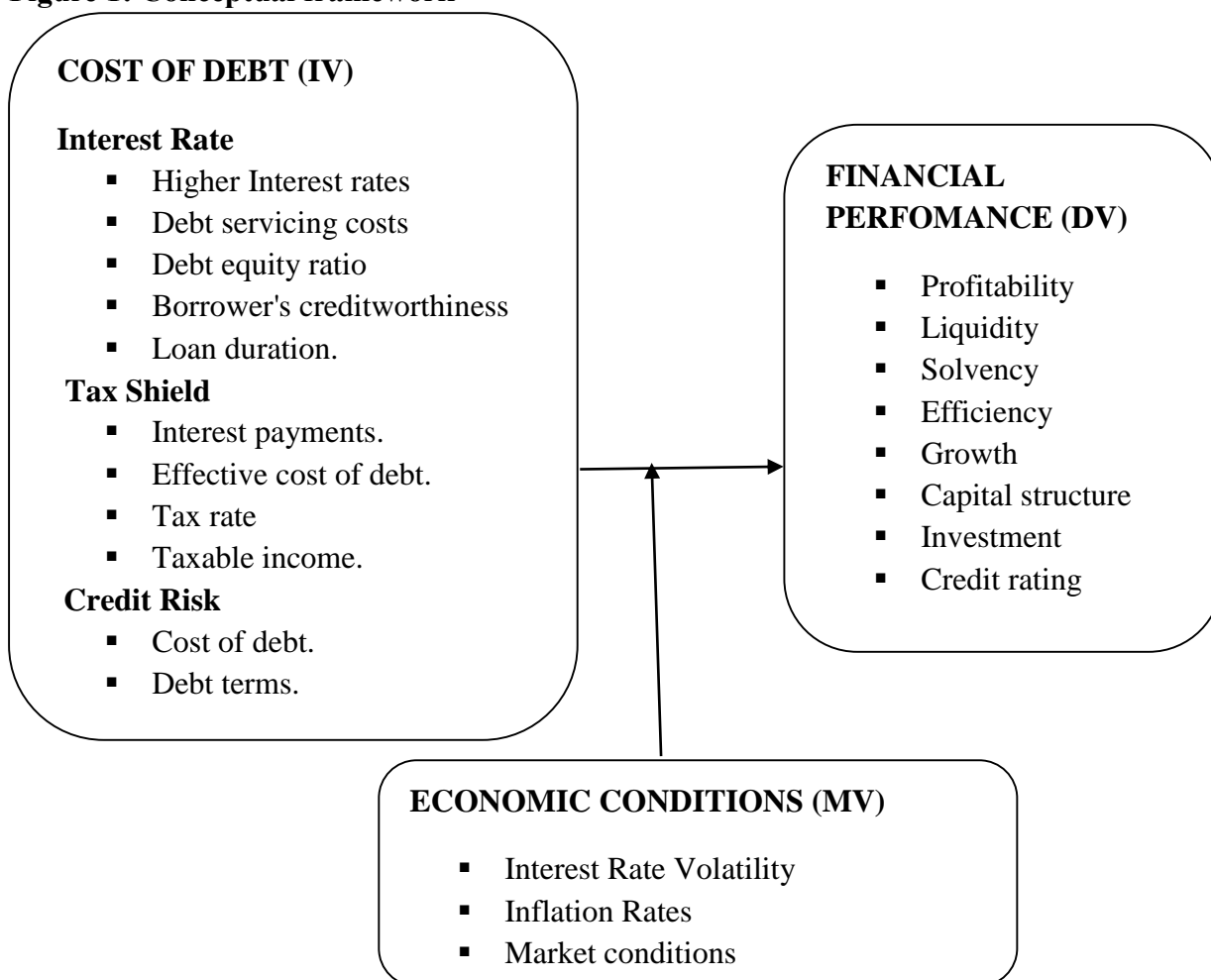
affect the firm's reputation, access to capital, and cost of financing, thereby influencing financial performance.

Collectively, these theories provide a comprehensive framework for analyzing how SMEs make financing decisions and how these decisions impact their financial performance. By applying these theoretical perspectives, the study can better understand the complexities of SME financing and develop strategies to optimize their capital structures.

### 2.3 Conceptual framework

The conceptual framework depicts the relationship between the Cost of Debt and the financial performance of small and medium enterprises (SMEs) in Lira city, Uganda. The independent variable is Cost of Debt, and the dependent variable is financial performance.

**Figure 1: Conceptual framework**



**Source:** *Adopted from Korajczyk & Levy (2003); Beck, Demirgüç-Kunt & Maksimovic (2005). Brealey, Myers & Allen (2020); Ross, Westerfield & Jaffe (2019); Brigham & Houston (2021); Graham & Harvey (2001), and modified by the researcher.*

The independent variable (IV), the cost of debt, is being operationalised as Interest Rate, Tax Shield, and Credit Risk, while the dependent variable (DV), financial performance, is operationalised as Profitability, Liquidity, Solvency, Efficiency, and Growth. The framework also presents the Moderating Variable (MV) as Economic Conditions, which is operationalised as Interest Rate Volatility, Inflation Rate Trends, and Access to Credit. The researcher adopted a many-to-one approach to examine how the cost of debt affects the financial performance of small and medium enterprises (SMEs) in Lira city, Uganda.

## **2.4 Empirical Review**

### **2.4.1 Interest Rate and Financial Performance**

The relationship between interest rates and financial performance continues to attract considerable scholarly attention, particularly in light of fluctuating global economic conditions and the growing reliance of small and medium enterprises (SMEs) on debt financing. Interest rate, as a component of the cost of debt, directly affects the borrowing costs of SMEs, influencing their profitability and growth trajectories.

Claessens et al. (2018) examined the impact of prolonged low-interest rates in advanced economies and found that while such rates initially support financial performance by reducing borrowing costs, over time they compress net interest margins and erode profitability. Similarly, Borio and Gambacorta (2017), using data from 108 banks across 14 advanced economies, observed that persistently low interest rates encourage excessive risk-taking among firms, potentially threatening long term financial health. These findings imply that even though SMEs benefit initially from lower interest expenses, they may face heightened risk during interest rate normalization periods. Altavilla, Boucinha, and Peydró (2018), focusing on the Eurozone, reported that negative interest rate policies incentivized lending and temporarily improved financial metrics but also stressed bank profitability with indirect consequences for SMEs.

In developing economies, the sensitivity of SMEs to interest rates is even more pronounced. Rahman, Uddin, and Noman (2019) found in Bangladesh that increases in interest rates significantly reduce SME profitability due to higher debt servicing costs. Beck (2013) similarly noted that underdeveloped financial systems limit SMEs' access to affordable credit, thereby amplifying the negative effects of rate hikes.

Recent evidence from East Africa reinforces this perspective. Eton, Mwosi, Mutesigensi, and Ebong (2017), studying SMEs in Lira Municipality, Uganda, revealed that high lending rates often exceeding

20% directly constrain SME profitability and increase default risks. In Kenya, Ngugi, Maingi, and Muturi (2020) observed that commercial bank lending rates significantly influenced SME performance, with rising rates linked to reduced liquidity and growth potential. Likewise, a Tanzanian study by Kira and He (2012) demonstrated that SMEs' access to finance is highly sensitive to interest rate fluctuations, where high borrowing costs discourage credit uptake and weaken financial sustainability. These regional findings align with the broader literature but highlight the unique vulnerabilities of SMEs in Sub-Saharan Africa, where financial systems are less diversified and credit risk is elevated.

More broadly, Banerjee, Kharroubi, and Gambacorta (2020) showed that SMEs tend to over-leverage during periods of low interest rates, exposing themselves to financial instability when rates rise. Bunn et al. (2018) confirmed similar dynamics in emerging markets, where low interest rates spur short-term performance but often lead to over-indebtedness due to weak regulation and financial literacy. Sector-specific research adds nuance: Almeida and Campello (2007) showed that capital intensive firms are more exposed to interest rate fluctuations than innovation-driven firms, while Hall and Lerner (2010) noted that technology firms maintain stronger profit margins regardless of rate changes. Kashyap et al. (2020) further emphasized that financially healthier firms are able to negotiate more favorable borrowing terms, cushioning themselves from adverse rate effects.

Despite the growing literature, several gaps remain. First, most studies focus on short-term effects, leaving limited evidence on the long-term impacts of interest rate exposure on SME sustainability. Second, empirical work in Sub-Saharan Africa, particularly in Uganda and East Africa, remains sparse, with existing studies either narrowly focused or generalizing findings across regions (Eton et al., 2017; Kira & He, 2012). Third, the behavioral dimension—how SME managers perceive, assess, and respond to interest rate risks remains underexplored (Howton & Perfect, 1998; Graham et al., 2015). Finally, the potential of financial technology (fintech) to mitigate interest rate risk is insufficiently examined, despite fintech's growing importance in SME financing (Thakor, 2020; Gomber et al., 2018).

Overall, while global literature underscores the importance of interest rates in shaping SME financial performance, regional evidence from East Africa highlights a sharper vulnerability due to underdeveloped financial systems, high lending costs, and weak risk management practices. This suggests the need for further localized empirical inquiry into how interest rates affect SMEs' long-term financial sustainability in Uganda and the broader East African region.

## 2.4.2 Tax Shield and Financial Performance

Tax shields represent a key theoretical and practical aspect of corporate finance, offering a reduction in taxable income through interest deductions and other allowable expenses, thereby influencing firms' financial outcomes. The foundational work by Modigliani and Miller (1963) established that tax deductibility of interest provides firms with a financing advantage, increasing firm value through the tax shield benefit. This foundational theory has since spurred extensive empirical investigation.

Graham (2000), through a simulation-based analysis of U.S. firms, demonstrated that firms with higher profitability and consistent taxable income derive significant benefits from interest tax shields. However, he also noted diminishing returns when firms excessively rely on debt, leading to elevated financial risk. Similarly, Myers (2001) highlighted the trade-off between tax benefits and potential bankruptcy costs, a dynamic particularly relevant for SMEs with limited equity buffers.

Hanlon and Heitzman (2010), in a comprehensive literature review, noted that tax shields from non-debt sources such as depreciation are especially valuable for capital-intensive sectors. Desai and Dharmapala (2009) expanded this perspective, illustrating that while tax shields can improve firm performance, aggressive tax strategies associated with excessive reliance on such shields may lead to reputational damage and regulatory penalties. Armstrong, Blouin, and Larcker (2012) further asserted that firms with substantial tax shields tend to adopt aggressive tax avoidance strategies, which can hurt long-term performance if not balanced with sound governance.

Recent studies offer nuanced insights. Blouin et al. (2020), using firm-level data from OECD countries, found that strong corporate governance enables firms to harness tax shields responsibly, enhancing financial outcomes without resorting to risky tax practices. Meanwhile, Liu et al. (2021) examined the strategic use of tax shields during the COVID-19 pandemic and found that firms in distressed sectors intensified their use of depreciation-based shields to maintain liquidity, underscoring the shields' role in crisis resilience.

In the context of evolving tax regulations, Dyreng et al. (2022) analyzed the effects of global tax reforms such as the OECD's Base Erosion and Profit Shifting (BEPS) initiative. They concluded that the effectiveness of traditional tax shields is declining due to increased scrutiny and regulatory tightening, prompting firms to reassess their financial strategies. Similarly, Guenther, Matsunaga, and Williams (2022) noted a growing trend of firms integrating long-term tax strategy considerations into corporate planning due to changing international tax landscapes.

Despite these advances, several limitations persist. Empirical studies on SMEs specifically remain scarce, with most research focused on large multinational corporations. Furthermore, sectoral and regional diversity in the use and impact of tax shields is underexplored, particularly in low-income economies. The interaction between corporate governance and tax shield effectiveness is also insufficiently examined outside developed economies. Moreover, while depreciation and amortization-based shields have been studied extensively, their comparative effectiveness across sectors and tax regimes warrants further investigation.

Within East Africa, emerging evidence highlights similar challenges and opportunities. Waweru and Mangena (2014) observed that firms in Kenya often underutilize debt-related tax shields due to limited access to affordable credit and weak financial management structures. In Tanzania, Mzenzi and Gasper (2015) noted that SMEs rarely exploit tax shield advantages effectively, largely due to informality, lack of financial literacy, and inconsistent tax policy enforcement. In Uganda, Okello et al. (2025) and Eton et al. (2017) found that while SMEs recognize the potential benefits of interest tax deductibility, most studies have been qualitative in nature and have not disaggregated cost-of-debt components such as tax shields, interest rates, and credit risk. This underscores a significant research gap in understanding how SMEs in low-income contexts strategically deploy tax shields to enhance financial performance.

There is also a notable deficiency in empirical research that specifically investigates how small and medium enterprises (SMEs), particularly in developing countries, utilize tax shields as a financial management strategy (Abeywardhana, 2015; Nguyen & Ramachandran, 2020). Existing literature offers limited insights into the influence of internal corporate governance mechanisms, such as board structure and ownership concentration, on the adoption and effectiveness of tax shield strategies (Desai & Dharmapala, 2006; Lin et al., 2011). The effectiveness of tax shields in the context of evolving international tax regulations, particularly after the implementation of the OECD's Base Erosion and Profit Shifting (BEPS) framework, remains underexplored (OECD, 2015; Devereux et al., 2018). There is a scarcity of longitudinal studies that assess the long-term financial implications of tax shield utilization, especially during periods of economic instability or crisis (Graham & Tucker, 2006; Dyreng et al., 2010).

Despite the above limitations, the reviewed works, including those from East Africa, provide valuable insights for contextualizing tax shields as a critical component of the cost of debt and their potential influence on SME financial performance.

### **2.4.3 Credit Risk and Financial Performance**

Credit risk, defined as the likelihood that a borrower will default on debt obligations, remains a fundamental concern for financial health across institutions. Foundational literature has long recognized the adverse implications of unmanaged credit risk on firm performance, particularly profitability and liquidity. Altman and Saunders (2001) highlighted the historical evolution of credit risk measurement and emphasized the role of robust risk assessment in maintaining financial performance. Similarly, Berger and DeYoung (1997) found a direct correlation between problem loans and declining cost efficiency, showing that poor credit risk management deteriorates financial outcomes.

Expanding beyond banking, Achou and Tenguh (2008) demonstrated in Cameroonian commercial banks that structured credit assessment mechanisms improved returns on assets (ROA). Poudel (2012) confirmed that credit risk indicators such as loan-to-asset ratios and default rates significantly influence financial outcomes. However, both studies focused on banks, leaving SMEs underrepresented.

Recent advances highlight technological transformation in credit risk management. Banna et al. (2022) found that AI-based credit scoring and digital monitoring reduced non-performing loans (NPLs) and improved ROE in Southeast Asian financial institutions. Similarly, Ozili (2021) showed that Nigerian banks with weak credit policies experienced higher NPLs during the COVID-19 pandemic, underscoring the importance of resilient risk frameworks.

In East Africa, emerging evidence underscores the relevance of credit risk for SMEs. Waweru and Kalani (2016) found that Kenyan SMEs with higher perceived credit risk faced limited access to affordable finance, constraining profitability. In Uganda, Eton et al. (2017) observed that SMEs in Lira Municipality experienced declining financial performance due to inadequate credit risk management and high default rates. Similarly, a study in Tanzania by Mzenzi and Gasper (2015) highlighted that SMEs often fail to implement formal credit assessment frameworks, increasing exposure to default risk and reducing financial sustainability. These studies indicate that SMEs in East Africa are particularly vulnerable due to informal lending practices, limited collateral, and weak regulatory enforcement.

Despite the growing body of research, gaps remain. Most studies focus on banks or large firms, leaving SMEs underrepresented. Cross-country comparisons are limited, and empirical testing of credit risk frameworks in non-financial SMEs in developing economies is sparse. This study seeks to fill this gap

by examining the impact of credit risk on SME financial performance in Uganda, considering contextual factors such as digital adoption, sector-specific risk exposure, and managerial capacity.

#### **2.4.4 Moderating Influence of Economic Conditions on Cost of Debt and Financial Performance**

The interplay between economic conditions, cost of debt, and financial performance has long been of interest in finance research. Modigliani and Miller (1958) initially posited that capital structure has no bearing on firm value in perfect markets, but acknowledged that taxes, inflation, and bankruptcy costs significantly alter this relationship. Myers and Majluf (1984) extended this through pecking order theory, noting that economic downturns increase financing costs, thereby impacting performance.

Empirical evidence supports these theoretical insights. Kayo and Kimura (2011) found that GDP growth and inflation significantly moderate the debt–performance relationship, with favorable economic conditions enhancing profitability while inflationary environments increase borrowing costs. Campello, Graham, and Harvey (2010) observed during the global financial crisis that liquidity stress and rising debt costs reduced investment and profitability across U.S., European, and Asian firms. Chen and Strange (2016) highlighted that inflation and exchange rate volatility in emerging Asian markets significantly elevate borrowing costs, lowering ROA and ROE.

In East Africa, evidence also demonstrates a moderating effect of economic conditions on SME financial performance. In Kenya, Ngugi et al. (2020) found that interest rate volatility and inflation negatively influenced SME liquidity and growth. In Uganda, Okello et al. (2025) observed that SMEs in Lira City experienced higher borrowing costs and reduced profitability during periods of local economic instability, including inflation spikes and credit market tightening. Similarly, Tanzanian SMEs studied by Mzenzi and Gasper (2015) showed that macroeconomic shocks amplified credit constraints, limiting debt-financed growth.

Recent multi-country analyses further reinforce these findings. Ghosh and Ghosh (2020) demonstrated that economic policy uncertainty magnifies the negative influence of debt costs on firm performance, while Alam, Tang, and Tian (2022) highlighted that proactive fiscal and monetary interventions mitigate adverse effects. These studies collectively indicate that economic conditions—such as inflation, interest rate volatility, and policy stability serve as crucial moderators in the cost of debt–financial performance relationship.

Despite these insights, existing studies often overlook SMEs, particularly in Sub-Saharan Africa. Limited attention has been paid to long-term moderating effects of persistent economic shocks or to informal-sector SMEs, which face unique exposure to economic volatility and credit constraints. This

study addresses these gaps by analyzing how economic conditions moderate the relationship between cost of debt and SME financial performance in Uganda, incorporating industry-specific and policy relevant indicators.

**Table 1: Below, find a summarized literature review matrix in tabular format, aligning with the study**

<b>Study</b>	<b>Focus</b>	<b>Methodology</b>	<b>Key Findings</b>	<b>Limitations</b>	<b>Gaps Identified</b>
Esho & Liaw (2002)	Interest rate risk and bank performance	Panel data analysis	Interest rate exposure significantly affects financial institutions' performance	Did not focus on SMEs; short-term analysis	Lack of longitudinal data on interest rate exposure and long-term SME performance
Flannery & James (1984)	Interest rate sensitivity in financial firms	Time-series econometric modeling	Asset/liability maturity mismatch impacts performance	Focused on U.S. financial firms; data from the 1970s–1980s	No long-term SME-specific insights into interest rate sensitivity
Beck et al. (2005)	SMEs and access to finance in developing economies	Cross-country regression	SMEs face financing challenges that affect their growth	Lacked focus on financial risk exposure, like interest rates	Limited research on SMEs' financial risks in African and underrepresented regions
Ayyagari et al. (2011)	SME financing constraints globally	World Bank Enterprise Survey analysis	Institutional environment shapes SME financing patterns	Did not include macroeconomic factors like interest rate volatility	Geographical bias and limited exploration of the economic condition impacts on SMEs
Howton & Perfect (1998)	Managerial use of derivatives for interest rate risk management	Survey and regression	Firms with active interest rate management perform better	Focused on large firms; limited SME application	Inadequate exploration of managerial decision-making in SME interest rate risk management

Graham et al. (2015)	Corporate financial policies under economic uncertainty	Survey-based study	Decision-making is strongly affected by market volatility	Excluded SME-specific behavior	Lack of SME-focused studies on financial decision-making in changing interest rate environments
Thakor (2020)	Fintech and innovation in financial services	Conceptual and case studies	Fintech enhances efficiency and access in financial markets	Did not empirically assess risk management impact on SMEs	Sparse empirical evidence on the role of fintech in managing interest rate risk in SMEs
Gomber et al. (2018)	Digital transformation and financial innovation	Systematic literature review	Fintech adoption increases competitiveness and reduces transaction costs	Lacked industry-specific and risk-focused empirical data	Insufficient evidence on fintech applications for interest rate risk management in SME contexts

### Summary of the literature review

The reviewed literature indicates that the cost of debt, comprising interest rates, tax shields, and credit risk, has a significant influence on the financial performance of SMEs, though most empirical research has focused on large firms or banks in developed economies (Altman & Saunders, 2001; Berger & DeYoung, 1997; Graham, 2000; Myers, 2001). Globally, high or volatile interest rates increase borrowing costs and reduce profitability, while tax shields provide financial relief but require careful governance to avoid excessive risk (Desai & Dharmapala, 2009; Hanlon & Heitzman, 2010). Credit risk remains a major determinant of firm performance, with poor risk management leading to defaults, reduced liquidity, and lower returns (Achou & Tenguh, 2008; Poudel, 2012). Emerging evidence from East Africa, including studies from Uganda, Kenya, and Tanzania, confirms that SMEs are particularly vulnerable due to underdeveloped financial systems, limited access to affordable credit, weak managerial capacity, and macroeconomic volatility (Eton et al., 2017; Mzenzi & Gasper, 2015; Waweru & Kalani, 2016; Okello et al., 2025; Ngugi et al., 2020). Furthermore, economic conditions such as inflation, interest rate fluctuations, and policy uncertainty moderate the relationship between cost of debt and financial performance, highlighting the importance of contextual factors in SME sustainability (Alam, Tang, & Tian, 2022; Ghosh & Ghosh, 2020; Kayo & Kimura, 2011). Despite these insights, gaps

persist, particularly regarding the disaggregated effects of debt components, long term impacts, and the role of financial innovation in mitigating risks, underscoring the need for localized empirical research in underrepresented regions like northern Uganda.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.0 Introduction**

This chapter presents the research methodology used to investigate the impact of the cost of debt on the financial performance of SMEs in Lira City, Uganda. It provides a detailed explanation of the research design, approach, study population, sampling techniques, sample size, data sources, data collection instruments, and measures adopted to ensure validity, reliability, and ethical compliance. Each research objective is aligned with specific methodological procedures to ensure rigor and clarity in addressing the study's aims.

#### **3.1 Research Design**

The study employed a descriptive and correlational research design. The descriptive design was used to provide a detailed account of the current state of the cost of debt and financial performance among SMEs in Lira City, including key financial behaviors, challenges, and management strategies (Saunders, Lewis, & Thornhill, 2016). The correlational design enabled the examination of relationships between cost of debt components—such as interest rates, tax shields, and credit risk—and financial performance metrics, including profitability and liquidity. This approach highlighted how variations in debt levels affect the financial outcomes of SMEs (Creswell, 2014; Beck, Demirguc-Kunt, & Levine, 2005).

#### **3.2 Research Approach**

A mixed-methods approach, combining quantitative and qualitative methods, was employed. Quantitative data were collected to measure numerical relationships between cost of debt components and financial performance indicators, thereby enabling statistical analysis and the generation of generalizable insights (Creswell & Creswell, 2017). Qualitative data were gathered through interviews to capture contextual insights, managerial perspectives, and nuanced experiences regarding debt management and financial decision-making among SMEs (Yin, 2015). The integration of both approaches ensured a comprehensive understanding of the complex dynamics between the cost of debt and SME financial performance (Tashakkori & Teddlie, 2010).

#### **3.3 Study Population**

The study population comprised approximately 340 individuals drawn from various key stakeholder groups to ensure a representative analysis. These included SME owners and managers, who provided

critical insights into the cost of debt and financial performance, with an anticipated sample of about 230 participants (Bryman, 2016). Financial officers and accountants within these SMEs were also included to provide detailed financial data, targeting approximately 35 participants. To incorporate a local governance perspective, interviews were conducted with representatives from the Lira City Council’s Commercial Department, with a sample size of about 25 individuals. These officials offered valuable insights into the economic environment and policy implications affecting SMEs in the region (Lira City Council, 2024). Additionally, representatives from local financial institutions—such as loan officers and credit managers—were interviewed, targeting approximately 25 individuals. This diverse population ensured comprehensive data collection, reflecting multiple dimensions of the relationship between the cost of debt and financial performance in the SME sector (Creswell & Creswell, 2017; Saunders, Lewis, & Thornhill, 2016). The population figures were derived from updated SME registries provided by the Lira City Council (2024), ensuring current and representative sampling.

### 3.4 Sampling Techniques and Sample Size

Random sampling was employed to select SME owners and managers, ensuring that each individual had an equal chance of being included in the study and thereby enhancing representativeness. Purposive sampling was used for financial institutions, city and local government officials, and business development stakeholders, as these respondents were chosen based on their expertise, roles, and relevance to the research objectives.

The sample size of 230 respondents was determined using Krejcie and Morgan’s (1970) table for population proportion, ensuring adequate representation across all groups. Table 3.1 summarizes the sampling:

<b>Group</b>	<b>Population</b>	<b>Sample Size</b>	<b>Sampling Technique</b>
SME Owners and Managers	255	152	Random Sampling
Financial Institutions Representatives	35	32	Purposive Sampling
City & Local Government Officials	25	23	Purposive Sampling
Business Development Stakeholders	25	23	Purposive Sampling
<b>Total</b>	<b>340</b>	<b>230</b>	—

Source: *Lira City Council. (2024); Krejcie& Morgan (1970).*

### 3.6 Data Sources and Procedures

A combination of primary and secondary data sources was utilized for the current study to provide a comprehensive analysis. Primary data will be collected through surveys and questionnaires distributed to 152 SME owners and managers. This structured questionnaire gathers quantitative data on the cost of debts, financial performance metrics, and management practices, incorporating both closed and open-ended questions to capture detailed financial information and perceptions (Creswell & Creswell, 2017). Additionally, semi structured interviews were conducted with 32 representatives from financial institutions, 23 city and local government officials, and 23 stakeholders from business development service providers. These interviews will offer qualitative insights into debt management practices, financial regulations, and economic policies affecting SMEs (Yin, 2015).

Secondary data was sourced from financial records and reports of SMEs, including balance sheets, income statements, and loan agreements, to analyze the relationship between the cost of debt and financial performance metrics such as profitability and liquidity (Saunders, Lewis, & Thornhill, 2016). Furthermore, government and industry reports from the Lira City Council and relevant industry associations will provide contextual information on economic conditions, SME performance, and regulatory frameworks impacting the cost of debt (Lira City Council, 2023). This combination of primary and secondary data ensured a thorough and well-rounded perspective on the study's focus, enhancing the reliability and depth of the analysis.

### **3.7 Data Collection Methods and Instruments**

In the current study, three key data collection methods were utilized to gather comprehensive information. The survey method involved the use of a structured questionnaire designed to collect quantitative data from SME owners and managers. This questionnaire featured both closed and open-ended questions to capture detailed insights on the cost of debt, financial performance metrics such as profitability and liquidity, and management practices. Closed-ended questions used Likert scales to measure attitudes and perceptions, while open-ended questions allowed for additional qualitative insights (Creswell & Creswell, 2017).

The interview method employed a semi structured interview guide to gather in depth qualitative data from representatives of financial institutions, city and local government officials, and stakeholders from business development service providers. The interview guide included open ended questions aimed at exploring the nuances of debt management practices, financial regulations, and the effects of economic policies on SMEs. This approach provided flexibility to probe deeper into responses and adapt questions based on the expertise of the interviewees (Yin, 2015).

Additionally, a document review was conducted using a document review checklist to systematically analyze secondary data from financial records and reports of SMEs, such as balance sheets, income statements, and loan agreements. The checklist focused on key aspects, including cost of debt, financial performance indicators, and financial management practices, complementing the primary data collected through surveys and interviews (Saunders, Lewis, & Thornhill, 2016).

These methods collectively ensured a robust and comprehensive analysis of the cost of debt and financial performance in the context of SMEs in Lira City.

### Data Collection Methods and Instruments Matrix

Data Collection Method	Instrument	Target Respondents	Type of Data	Purpose/Focus
Survey	Structured questionnaire	SME owners and managers	Quantitative and qualitative	Measure cost of debt components, financial performance (profitability, liquidity), and management practices
Interview	Semi-structured interview guide	Financial institutions, city and local government officials, business development service providers	Qualitative	Explore debt management practices, financial regulations, economic policy effects, and SME financing challenges
Document Review	Document review checklist	SME financial records (balance sheets, income statements, loan agreements)	Quantitative and qualitative	Verify and analyze cost of debt, financial performance indicators, and financial management practices

### 3.8 Data Quality Control

Data quality control was essential in ensuring that the findings on the cost of debt and financial performance of SMEs in Lira City were both valid and reliable. To achieve validity, the study employed well-structured questionnaires and interview guides developed based on relevant financial management and SME literature, as well as expert input, to ensure alignment with the study objectives (Creswell & Creswell, 2017; Saunders, Lewis, & Thornhill, 2016). The instruments specifically targeted dimensions corresponding to each study objective: interest rates, tax shields, credit risk, financial performance indicators (profitability and liquidity), and economic conditions as a moderating factor.

Content validity was assessed using the Content Validity Index (CVI), where experts in financial management, SME operations, and local economic policy reviewed the instruments for clarity, relevance, and comprehensiveness. The CVI was calculated as:

$$CVI = \frac{\text{Total Number of items declared Valid}}{\text{Total Number of Items in the Instrument}}$$

**Table 3.3: Validity Results**

Variable	Number of Items	CVI
Interest Rate	10	0.815
Tax Shield	8	0.800
Credit Risk	10	0.820
Financial Performance	12	0.810
Economic Conditions	5	0.805
Total	45	0.810

As shown in Table 3.3, each dimension achieved a CVI above the minimum recommended threshold of 0.70 (Amin, 2005), with an overall CVI of 0.810, confirming that the instruments were valid and appropriate for measuring the key constructs of the study.

To ensure reliability, the instruments were pretested with a pilot sample of 25 SME owners and managers from a similar urban district in northern Uganda. Feedback from the pilot helped refine the language, structure, and flow of items. Internal consistency was measured using Cronbach's Alpha Coefficient, and all dimensions achieved scores above the recommended minimum of 0.70, confirming their reliability (Field, 2018; Nunnally & Bernstein, 1994). Test-retest reliability was also conducted by administering the same instruments to a sub-sample at two different time points to assess temporal stability, further enhancing the robustness of the tools (Saunders et al., 2019).

**Table 3.4: Reliability Results**

Variable	Number of Items	Cronbach's Alpha
Interest Rate	10	0.875
Tax Shield	8	0.860
Credit Risk	10	0.880
Financial Performance	12	0.890
Economic Conditions	5	0.850
Total	45	0.871

The overall reliability coefficient of 0.871 indicated a high level of internal consistency and dependability of the instruments. Additionally, for interviews, inter-rater reliability was ensured by having multiple researchers independently code responses and then compare findings to maintain consistency in interpretation (Yin, 2015).

These measures of validity and reliability ensured that the data collected for the study on interest rates, tax shields, credit risk, and economic conditions in relation to SME financial performance in Lira City were both accurate and dependable, enhancing the robustness and credibility of the research findings.

### 3.8 Alignment of Methodology to Research Objectives

<b>Research Objective</b>	<b>Data Collection Method</b>	<b>Instrument</b>	<b>Sample</b>	<b>Analytical Approach</b>
To examine the effect of interest rates on SME financial performance	Survey & Document Review	Questionnaire & Financial Records	152 SME owners/managers	Correlation & Regression Analysis
To assess the impact of tax shields on SME financial performance	Survey & Document Review	Questionnaire & Financial Records	152 SME owners/managers	Correlation & Regression Analysis
To evaluate the influence of credit risk on SME financial performance	Survey, Interviews & Document Review	Questionnaire, Interview Guide, Financial Records	152 SME owners/managers; 78 stakeholders	Correlation & Thematic Analysis
To determine the moderating role of economic conditions	Survey & Interviews	Questionnaire & Interview Guide	152 SME owners/managers; 78 stakeholders	Moderated Regression & Qualitative Analysis

### 3.9 Data Collection Procedure

For the study on the cost of debt and financial performance of selected SMEs in Lira City, Uganda, a systematic data collection procedure was employed to ensure that comprehensive and accurate information was gathered.

The data collection process began with the preparation phase, which involves developing and finalizing the research instruments, including the survey questionnaire and interview guides. The instruments were designed based on a thorough review of the literature and consultation with financial experts to ensure they are valid and relevant to the study's objectives (Creswell & Creswell, 2017). Once the instruments were developed, a pilot test was conducted with a small sample of SMEs to identify and address any issues with question clarity or format, ensuring that the final version is both reliable and valid (Saunders, Lewis, & Thornhill, 2016).

Primary data collection proceeded with the distribution of the structured questionnaires to 255 SME owners and managers. This was achieved through a combination of direct distribution and online surveys, depending on accessibility and convenience. The survey was administered with clear instructions and a deadline for completion to maximize response rates. To ensure high response rates and data quality, follow-up reminders were sent to participants who had not completed the survey by the deadline (Field, 2018).

Interviews were scheduled with representatives from financial institutions, city and local government officials, and business development service providers. The semi-structured interview guide was used to facilitate these interviews, which were conducted either in person or via video conferencing, depending on the availability and location of the interviewees. Each interview was audio-recorded with the participant's consent, and detailed notes were taken to ensure accurate data capture. The interviews were transcribed verbatim, and the transcripts will be analyzed to identify themes and insights relevant to debt management and financial performance (Yin, 2015).

Secondary data collection involved reviewing financial records and reports of SMEs, including balance sheets, income statements, and loan agreements. These documents were obtained from SME records, financial institutions, and relevant government reports. A document review checklist was used to systematically extract and organize the data, focusing on key financial indicators and debt-related information (Saunders, Lewis, & Thornhill, 2016).

Overall, this structured and systematic approach ensured that the data collected was comprehensive, accurate, and relevant, supporting robust analysis of the cost of debt and financial performance among SMEs in Lira City.

### **3.10 Data Analysis**

For the study on the cost of debt and financial performance of SMEs in Lira City, Uganda, both quantitative and qualitative data analysis methods were employed to provide a comprehensive understanding of the relationships and patterns in the data.

#### **3.10.1 Quantitative Data Analysis**

Quantitative data analysis involved statistical techniques to analyze the numerical data collected through the structured questionnaires. The analysis started with descriptive statistics, including mean, median, mode, standard deviation, and frequency distributions, to summarize the basic features of the data and provide an overview of the cost of debts and financial performance metrics (Field, 2018). Next, inferential statistics were used to explore relationships and test hypotheses. Correlation analysis assessed

the strength and direction of the relationship between the cost of debt and financial performance variables such as profitability and liquidity. Multiple regression analyses were conducted to determine the extent to which the cost of debt impacts financial performance while controlling for other variables (Creswell & Creswell, 2017). Statistical software SPSS was used to perform these analyses, ensuring accuracy and reliability in the results. The findings were interpreted to identify significant patterns and draw conclusions about the impact of the cost of debt on SME financial performance.

### **3.10.2 Qualitative Data Analysis**

Qualitative data analysis focused on the data collected from semi-structured interviews and document reviews. The analysis began with transcription and coding of interview recordings to convert verbal data into text for detailed examination. A coding framework was developed to categorize responses into themes related to debt management practices, financial regulations, and economic impacts (Yin, 2015). Thematic analysis was used to identify recurring themes and patterns across interview transcripts, providing deeper insights into the qualitative aspects of cost of debt and financial performance (Braun & Clarke, 2006). Document review data was analyzed using content analysis to systematically evaluate financial records and reports, focusing on key indicators of cost of debts and performance metrics (Saunders, Lewis, & Thornhill, 2016). The qualitative findings were integrated with quantitative results to provide a comprehensive understanding of the study's focus, offering a rich, contextual interpretation of how the cost of debt affects financial performance in SMEs.

By employing these quantitative and qualitative analysis methods, the study achieved a robust and nuanced understanding of the factors influencing the cost of debt and financial performance among SMEs in Lira City.

### **3.11 Ethical Considerations**

In conducting the study on the cost of debt and the financial performance of SMEs in Lira City, Uganda, several ethical considerations were essential to ensure the integrity of the research and the protection of participants' rights.

***Informed Consent:*** All participants, including SME owners and managers, financial institution representatives, city and local government officials, and business development stakeholders, were provided with a clear and comprehensive informed consent form before data collection began. This form outlined the purpose of the study, the nature of their participation, potential risks and benefits, and their right to withdraw from the study at any time without penalty (Creswell & Creswell, 2017). Participants were asked to sign the consent form to confirm their voluntary participation.

**Confidentiality:** The confidentiality of participants' information was strictly maintained throughout the study. Personal identifiers were removed from the data, and all responses were anonymized to prevent the identification of individual participants or organizations (Saunders, Lewis, & Thornhill, 2016). Data was stored securely in password-protected electronic files and locked physical storage to safeguard against unauthorized access.

**Data Privacy:** During data collection, both the survey responses and interview transcripts were handled with utmost care to protect participants' privacy. Participants were assured that their responses will only be used for research purposes and will not be shared with unauthorized parties (Yin, 2015). In the case of document reviews, any sensitive information was treated with discretion and only relevant data was utilized for analysis.

**Ethical Approval:** The study sought approval from Muni University and Lira City Council before commencing data collection. This step ensured that the research complies with ethical standards and that potential risks are adequately addressed (Braun & Clarke, 2006).

**Transparency:** The research process, including data collection, analysis, and reporting, was conducted transparently to maintain the study's credibility and integrity. Participants were informed of the study's findings and how the results would be used (Field, 2018).

**Avoiding Harm:** Efforts were made to minimize any potential harm to participants, such as stress or discomfort, particularly during interviews. Participants were encouraged to express concerns and withdraw if they felt uncomfortable at any stage of the study (Creswell & Creswell, 2017).

By adhering to these ethical considerations, the study ensured that it was conducted with respect for participants' rights and well-being, contributing to the overall credibility and ethical integrity of the research.

### **3.11.1 Limitations and Remedies of the Study**

In the study on the cost of debt and financial performance of SMEs in Lira City, Uganda, several limitations arose, and remedies were deployed to address these challenges.

**Limited Generalizability:** The findings from the study were limited in their generalizability beyond the SMEs in Lira City due to the localized nature of the sample. SMEs in different regions or countries might experience different debt management practices and financial performance outcomes. To mitigate this limitation, the study provided detailed contextual information about Lira City, which can help in understanding the local economic environment and its impact on the findings. Additionally, comparisons

with similar studies in other regions offered insights into the broader applicability of the results (Saunders, Lewis, & Thornhill, 2016).

**Response Bias:** There was a risk of response bias in survey and interview data, where participants were likely to provide socially desirable answers or withhold information due to concerns about confidentiality. To address this, the study ensured anonymity and confidentiality of responses and emphasized the importance of honest and accurate feedback. The use of neutral language and carefully worded questions helped minimize social desirability bias (Field, 2018). Triangulating survey data with qualitative interview data and document review also provided a more balanced view and reduced the impact of individual biases.

**Data Access Challenges:** Obtaining accurate and comprehensive financial data from SMEs and financial institutions was challenging due to privacy concerns or incomplete records. To remedy this, the study used a combination of primary data collection methods (surveys and interviews) and secondary data sources (financial records) to cross-verify information. Additionally, establishing a good rapport with participants and explaining the purpose of data collection improved cooperation and data quality (Yin, 2015).

**Sample Size Limitations:** The sample size was likely to be limited due to constraints in accessing a sufficient number of SMEs and key stakeholders in Lira City. To enhance the robustness of the findings, the study employed stratified random sampling to ensure representation across different SME categories and purposive sampling for specific stakeholder groups. If sample size limitations arose, the study acknowledged this in the analysis and considered it a potential limitation in interpreting the results (Creswell & Creswell, 2017).

**Economic Fluctuations:** Economic conditions in Lira City were likely to change during the study period, affecting the cost of debts and financial performance. To account for this, the study included a review of recent economic trends and considered their impact on the data analysis. Temporal variations were discussed in the findings to contextualize the results within the broader economic environment (Braun & Clarke, 2006).

By acknowledging these limitations and implementing the proposed remedies, the study aimed to ensure the validity and reliability of its findings and provide meaningful insights into the cost of debt and financial performance among SMEs in Lira City.

## CHAPTER FOUR

### DATA ANALYSIS, PRESENTATION, AND INTERPRETATION

#### 4.0 Introduction

This chapter discusses the objectives of the study as follows;

- i. To establish the relationship between interest rate and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.
- ii. To assess the effect of Tax shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City,
- iii. To determine the contribution of Credit risk to the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.
- iv. To examine the moderating influence of Economic conditions on the cost of debt and the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

#### 4.1 Demographic Characteristics of Respondents

##### Response Rate

**Table 2: Showing response rate**

<b>Response Rate</b>	<b>Frequency</b>	<b>Percentage</b>
Response rate from Questionnaires	230	67.6
Response rate from the Interview Guide	17	5
Total Response Rate	247	72.6
Non-Response Rate	93	27.4
<b>Total</b>	<b>340</b>	<b>100.0</b>

**Source: (Primary data, 2025)**

According to Mugenda and Mugenda (2003), a response rate of 50% is considered adequate for analysis and reporting, while a response rate of 60% is regarded as good. A response rate of 70% or above is classified as very good, indicating a high level of participation and reliability of the collected data. In comparison to these established benchmarks, the total response rate of 72.6% achieved in this study falls within the very good category. This suggests that the level of participation from respondents was strong and that the data collected can be considered highly representative of the target population.

**Table 3: Demographic Characteristics of Respondents**

Variable	Options	Frequency	Percent
Gender	Male	105	45.7
	Female	125	54.3
	Total	230	100
Age (Years)	18-25	34	14.8
	26-35	121	52.6
	36-45	70	30.4
	46-55	5	2.2
	Total	230	100
Education Level	Primary	10	4.3
	Secondary	3	1.3
	Diploma	110	47.8
	Degree	107	46.5
	Total	230	100
Business Sector	Retail	49	21.3
	Manufacturing	52	22.6
	Services	72	31.3
	Others	57	24.8
	Total	230	100
Years in Operation	Less than 1 year	66	28.7
	1-3 Years	54	23.5
	4-6 Years	44	19.1
	7 years and above	66	28.7
	Total	230	100
Source of Business Financing	Personal Savings	42	18.3
	Bank Loan	48	20.9
	SACCO	43	18.7
	Microfinance	48	20.9
	Others	49	21.3
	Total	230	100

**Source: Primary data (2025)**

Regarding gender, the data reveals that out of the total 230 respondents, 105 were male, representing 45.7% of the sample, while 125 were female, accounting for 54.3%. This indicates that the majority of the respondents were female, suggesting a higher participation of women in the study, which may reflect their increased involvement in business activities or their willingness to participate in research surveys.

In terms of age distribution, respondents were categorized into four age groups. The largest proportion of respondents, constituting 52.6%, fell within the age bracket of 26 to 35 years, highlighting that most of the business operators were young adults who were likely in the early or mid-stages of their entrepreneurial journey. The second-largest category included individuals aged 36 to 45 years, who accounted for 30.4% of the respondents. This suggests that a significant number of business operators were in their mid-career stage, possibly possessing substantial experience in business management. The youngest group, aged 18 to 25 years, comprised 14.8% of the respondents, indicating that relatively fewer young individuals were engaged in business activities. The least represented age group was those between 46 and 55 years, who made up only 2.2% of the total respondents, suggesting that older individuals may be less involved in entrepreneurial activities compared to their younger counterparts.

Concerning the level of education, the findings indicate that the majority of respondents had attained either a diploma or a degree qualification. Specifically, 47.8% of the respondents had completed a diploma, while 46.5% had obtained a degree. This implies that a substantial portion of business operators possessed tertiary education, which may contribute to better business management practices and decision-making. A relatively small proportion of respondents had only primary or secondary education, with 4.3% having completed primary education and 1.3% having attained secondary education. This suggests that higher education levels are common among business owners, possibly influencing their ability to access and utilize financial resources, adopt new business strategies, and engage in innovation.

Regarding the business sector, the data indicates that respondents were engaged in various business activities, with the majority operating in the services sector, which accounted for 31.3% of the sample. This highlights the significant role of the service industry in economic activities within the study area. The manufacturing sector followed closely, representing 22.6% of the respondents, while the retail sector comprised 21.3%, indicating that a considerable number of business owners were involved in trading activities. Additionally, 24.8% of the respondents belonged to the "other" category, suggesting engagement in various other sectors that were not explicitly categorized in the study.

The distribution of respondents based on the number of years their businesses had been in operation reveals that the highest proportion, constituting 28.7%, had been in operation for less than one year, suggesting that a significant number of businesses were relatively new ventures. Similarly, an equal

percentage of respondents (28.7%) reported that their businesses had been in operation for seven years or more, indicating the presence of both emerging and well-established businesses. Meanwhile, 23.5% of the businesses had been operating for one to three years, while 19.1% had been in existence for four to six years. This distribution demonstrates that while some businesses have survived for an extended period, a notable proportion is still in the early stages of growth and development.

In terms of business financing, the findings reveal that respondents relied on diverse sources to fund their business operations. A significant portion of the respondents (21.3%) accessed funding through sources categorized as "others," which may include informal financial assistance from friends, family, or other undisclosed means. Additionally, bank loans and microfinance institutions each accounted for 20.9% of the total financing sources, indicating that formal financial institutions played a crucial role in business funding. SACCOs (Savings and Credit Cooperative Organizations) were another common source of business financing, with 18.7% of respondents relying on them for financial support. Meanwhile, 18.3% of the respondents indicated that they used personal savings to finance their businesses, suggesting that self-funding remained a common practice among business owners.

**Table 4: Descriptive Statistics on Interest Rate and Financial Performance**

Statement	Strongly Disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly Agree (5)	Mean	StD
High interest rates negatively affect the profitability of my business.	9 (3.9%)	6 (2.6%)	4 (1.7%)	111 (48.3%)	100 (43.5%)	4.25	0.922
Increasing interest rates have made it difficult to maintain liquidity in my business.	15 (6.5%)	3 (1.3%)	17 (7.4%)	92 (40.0%)	103 (44.8%)	4.15	1.069
Interest rates influence the solvency of my business.	23 (10.0%)	4 (1.7%)	10 (4.3%)	85 (37.0%)	108 (47.0%)	4.09	1.217
The cost of borrowing affects the efficiency of business operations.	17 (7.4%)	8 (3.5%)	4 (1.7%)	89 (38.7%)	112 (48.7%)	4.18	1.132
Changes in interest rates influence the growth of my business.	13 (5.7%)	7 (3.0%)	8 (3.5%)	88 (38.3%)	114 (49.6%)	4.23	1.055

**Source: Primary Data, 2025**

### **High interest rates negatively affect the profitability of my business**

The statement that high interest rates negatively affect the profitability of businesses received strong agreement from the respondents. 43.5% strongly agreed, and 48.3% agreed, demonstrating a clear perception that high interest rates reduce business profitability. Only 3.9% of the respondents strongly disagreed, and 2.6% disagreed, showing a minimal minority who believe that interest rates do not impact profitability. Additionally, 1.7% of respondents were neutral on this issue, indicating that a small portion of business owners either did not have a strong opinion or were uncertain about the relationship between high interest rates and profitability. The mean score of 4.25 suggests that, on average, respondents strongly agree with the statement. The standard deviation of 0.922 indicates relatively low variability in responses, showing that most respondents hold similar views about the negative effect of high interest rates on profitability.

In response to an interview question, a senior loan officer at a financial institution said, *"High-interest rates have significantly reduced profit margins for many SMEs, as increased borrowing costs limit their ability to reinvest in business operations. A business development stakeholder added, "SMEs struggle to pass on these costs to consumers due to competitive market pressures, leading to reduced overall profitability". Nevertheless, a city government official mentioned that "Businesses with strong financial*

*planning tend to mitigate these effects through better debt management strategies."* (Source: KI001/08/03/2025)

### **Increasing interest rates have made it difficult to maintain liquidity in my business**

Regarding the statement on liquidity, 44.8% strongly agreed and 40.0% agreed, reinforcing the idea that rising interest rates have caused liquidity challenges for businesses. However, there were 6.5% of respondents who strongly disagreed and 1.3% who disagreed, indicating that a small group did not experience difficulties in maintaining liquidity despite increasing interest rates. Moreover, 7.4% of the respondents were neutral, implying that these respondents either did not feel the impact of rising interest rates on their liquidity or did not have a clear view on the matter. The mean score of 4.15 suggests a high level of agreement with the statement, while the standard deviation of 1.069 reveals moderate variability in responses, implying that the impact on liquidity might differ based on business circumstances, such as size, sector, or financial practices.

In answering an interview question, a representative from a business development organization explained that *"rising interest rates have constrained business liquidity, as higher loan repayments reduce available cash flow for operational expenses"*. Relatedly, a financial institution official noted that *"some businesses have opted for restructuring their loans or seeking alternative financing methods to maintain liquidity"*. However, a local government official suggested that *"well-established businesses with strong financial management practices are less affected by these fluctuations."* (Source: KI002/08/03/2025)

### **Interest rates influence the solvency of my business**

The statement about interest rates affecting the solvency of businesses showed that 47.0% strongly agreed and 37.0% agreed, indicating that most respondents believe interest rates influence their business solvency. However, 4.3% were neutral, and a minority of 10.0% strongly disagreed, suggesting that some respondents did not perceive a significant impact on solvency. The mean score of 4.09 indicates strong agreement, while the standard deviation of 1.217 reflects more variation in responses. This variability suggests that businesses with differing debt structures or financial management practices may experience different levels of solvency risk due to changing interest rates. The 4.3% neutral responses might indicate that some businesses are less affected by changes in interest rates or have stronger financial buffers.

In response to an interview guide question, a microfinance representative said, *"High borrowing costs force SMEs to allocate more resources to debt servicing rather than business expansion, reducing*

*overall operational efficiency*". A business consultant also emphasized that *"businesses that rely heavily on credit face challenges in maintaining productivity due to cash flow constraints*". A city official, however, stated that *"some SMEs have adapted by diversifying revenue streams to offset borrowing costs."* (Source: KI003/08/03/2025)

### **The cost of borrowing affects the efficiency of business operations**

For this statement, 48.7% strongly agreed and 38.7% agreed, reflecting the widespread belief that borrowing costs influence operational efficiency. Only 7.4% strongly disagreed, and 3.5% disagreed, suggesting a small number of respondents did not agree with the statement. Additionally, 1.7% were neutral, possibly indicating that some respondents either did not face borrowing costs or did not perceive these costs as having a significant impact on operational efficiency. The mean score of 4.18 reveals a strong agreement with the statement, and the standard deviation of 1.132 suggests some variability in the degree to which businesses feel the effect of borrowing costs, depending on their financial structure and industry sector.

A financial analyst from a commercial bank observed that *"volatile interest rates increase the risk of insolvency for SMEs with high debt exposure, particularly those in sectors with fluctuating revenues"*. A business development expert asserted that *"businesses with fixed-rate loans are less affected, while those with variable interest rates struggle to predict and manage costs effectively"*. A city government official added that *"financial literacy programs could help SMEs navigate these challenges more efficiently."* (Source: KI004/08/03/2025)

### **Changes in interest rates influence the growth of my business**

The statement on business growth showed that 49.6% strongly agreed and 38.3% agreed, indicating that a majority of respondents feel that changes in interest rates play a critical role in business growth. However, 3.5% were neutral, 3.0% disagreed, and 5.7% strongly disagreed, showing that some business owners do not perceive interest rate changes as a significant factor in their growth. The mean score of 4.23 reflects strong agreement with the statement, and the standard deviation of 1.055 suggests that most respondents have a similar perception, though some variability exists in how businesses are affected by changes in interest rates. The neutral responses here may indicate that some businesses are either unaffected by or less sensitive to changes in interest rates, possibly due to their business model or financial strategies.

While responding to interview questions a senior economist at a financial institution pointed out that *"high-interest rates limit SMEs' ability to expand operations, as borrowing for capital investment*

becomes more expensive”. A business owner in Lira City mentioned that “lower interest rates in past years enabled growth, but recent increases have slowed expansion plans”. A city official suggested that “policies supporting lower SME lending rates could stimulate business growth.” (Source: KI005/08/03/2025)

**Table 5: Relationship between Interest Rate and Financial Performance**

<b>Correlations</b>			
		<b>Interest Rate</b>	<b>Financial Performance</b>
<b>Interest Rate</b>	Pearson Correlation	1	.754**
	Sig. (2-tailed)		.000
	N	230	230
<b>Financial Performance</b>	Pearson Correlation	.754**	1
	Sig. (2-tailed)	.000	
	N	230	230
Correlation is significant at the 0.01 level (2-tailed).			

**Source: Primary Data, 2025**

The Pearson correlation coefficient between interest rate and financial performance is 0.754, which indicates a strong positive correlation between the two variables. This means that as interest rates increase, the financial performance of the business tends to improve, or conversely, as interest rates decrease, financial performance may decline. The strength of this correlation suggests that interest rates play a significant role in shaping the financial outcomes of businesses.

Given the strong positive correlation (0.754), businesses that are positively impacted by interest rate movements may experience an increase in profitability or growth when interest rates rise. Conversely, for businesses that are negatively impacted by higher interest rates (such as those with high borrowing costs), the relationship would suggest that lower interest rates could improve their financial performance. Since the correlation is highly significant ( $p = 0.000$ ), this indicates that the relationship between interest rates and financial performance is consistent and unlikely to be due to random variation. The finding implies that understanding and managing interest rate exposure could be crucial for businesses seeking to enhance their financial performance.

**Table 6: Descriptive Statistics on Tax Shield and Financial Performance**

Statement	Strongly Disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly Agree (5)	Mean	StD
The tax deductibility of interest payments improves my business's profitability.	2 (0.9%)	3 (1.3%)	5 (2.2%)	109 (47.4%)	111 (48.3%)	4.41	0.685
My business benefits from tax savings due to loan interest deductions.	9 (3.9%)	2 (0.9%)	7 (3.0%)	100 (43.5%)	112 (48.7%)	4.32	0.897
The tax shield on debt financing positively influences business liquidity.	20 (8.7%)	4 (1.7%)	8 (3.5%)	89 (38.7%)	109 (47.4%)	4.14	1.160
My business solvency improves due to the tax advantages of debt financing.	10 (4.3%)	6 (2.6%)	4 (1.7%)	96 (41.7%)	114 (49.6%)	4.30	0.962
Utilizing tax shields enhances the financial efficiency of my business.	10 (4.3%)	1 (0.4%)	3 (1.3%)	98 (42.6%)	118 (51.3%)	4.36	0.899

**Source: Primary Data, 2025**

### **The tax deductibility of interest payments improves my business's profitability**

The majority of respondents strongly agreed or agreed with the statement that the tax deductibility of interest payments improves their business profitability. Specifically, 48.3% strongly agreed, and 47.4% agreed. This strong consensus indicates that tax-deductible interest payments are considered a beneficial factor for profitability by most respondents. A very small percentage of respondents (0.9%) strongly disagreed, and 1.3% disagreed, highlighting that the negative impact of tax deductibility on profitability is virtually non-existent among the majority of respondents. Additionally, 2.2% of respondents were neutral, suggesting that a small portion of businesses either do not perceive this benefit or are unsure about its effects. The mean score of 4.41 reinforces this positive outlook, showing strong agreement with the statement, while the standard deviation of 0.685 reflects low variability in responses. This low variability suggests that most respondents share similar views on the profitability benefits of tax-deductible interest payments, making it a widely accepted practice for improving financial performance.

A tax expert from a financial institution, in response to interview questions, noted that “*tax deductible interest payments reduce taxable income, allowing SMEs to retain more profits*”. A business consultant highlighted that “*SMEs using debt strategically benefit the most, while those unaware of tax deductions*

*fail to maximize savings.* A city government official emphasized the need “*for increased awareness about tax incentives among SME owners.*” (Source: KI006/08/03/2025)

### **My business benefits from tax savings due to loan interest deductions**

On the statement regarding the benefits of tax savings from loan interest deductions, 48.7% of respondents strongly agreed, and 43.5% agreed, again indicating strong agreement. The majority of businesses acknowledged the advantages of loan interest deductions in terms of tax savings. Only 3.9% of respondents strongly disagreed, and 0.9% disagreed, showing a minimal minority who do not believe that loan interest deductions contribute to tax savings. Additionally, 3.0% of respondents were neutral, which suggests that a small number of businesses either do not fully recognize or experience the benefits of loan interest deductions. The mean score of 4.32 suggests a high level of agreement, and the standard deviation of 0.897 indicates moderate variability in responses, meaning that while most businesses benefit from these tax savings, some may experience less significant benefits based on their specific financial structures or practices.

A financial manager from a commercial bank, while responding to interview questions, stated that “*businesses actively seek tax benefits from debt financing through structured loans and financial planning*”. A business owner noted that “*some SMEs are unaware of these advantages and fail to utilize them effectively*”. A tax official from the city government suggested that “*training programs on tax efficiency could enhance SME financial sustainability.*” (Source: KI007/08/03/2025)

### **The tax shield on debt financing positively influences business liquidity**

For the statement on the influence of tax shields on business liquidity, 47.4% of respondents strongly agreed, and 38.7% agreed, indicating that most businesses feel that tax shields on debt financing help improve their liquidity. However, 8.7% of respondents strongly disagreed, and 1.7% disagreed, suggesting that some businesses either do not perceive or do not experience any improvement in liquidity due to tax shields. Additionally, 3.5% were neutral, indicating that a small proportion of businesses were either uncertain about the effects or did not find tax shields to have a significant impact on liquidity. The mean score of 4.14 indicates a moderate level of agreement, while the standard deviation of 1.160 suggests a higher level of variability in responses. This variability may reflect differences in business structures or industries, where some businesses may benefit more significantly from tax shields on debt financing, while others may not experience a noticeable effect on liquidity.

According to a financial consultant in response to interview questions, “*tax shields provide businesses with additional cash flow by reducing tax obligations, thereby improving liquidity*”. A representative

from a financial institution noted that *“businesses with high debt levels benefit more from tax shields, while those relying on equity financing see minimal impact”*. A government official emphasized *“the importance of financial planning to optimize tax advantages.”* (Source: KI008/08/03/2025)

### **My business solvency improves due to the tax advantages of debt financing**

The statement regarding the improvement of business solvency due to tax advantages of debt financing received strong agreement, with 49.6% strongly agreeing and 41.7% agreeing. This shows that a significant portion of businesses believe that tax advantages associated with debt financing contribute positively to their financial stability. 4.3% of respondents strongly disagreed, and 2.6% disagreed, representing a small group who do not perceive any positive effects on solvency from debt financing tax advantages. Additionally, 1.7% of respondents were neutral, suggesting that some businesses do not experience noticeable solvency improvements from this practice. The mean score of 4.30 indicates strong agreement, and the standard deviation of 0.962 reflects moderate variability in responses. This variability could be due to differences in how businesses manage their debt obligations and the relative importance of tax advantages in improving solvency, depending on the industry or the size of the business.

A tax policy analyst from a business association, in response to interview questions, stated that *“effective use of tax shields strengthens financial stability by reducing financial strain on businesses”*. A business owner mentioned that *“while tax shields help, they are not a substitute for sound financial management”*. A financial institution representative highlighted that *“tax incentives alone cannot prevent insolvency if businesses mismanage debt.”* (Source: KI009/08/03/2025)

### **Utilizing tax shields enhances the financial efficiency of my business**

In response to the statement about utilizing tax shields to enhance financial efficiency, 51.3% of respondents strongly agreed, and 42.6% agreed, showing a strong belief in the positive impact of tax shields on improving financial efficiency. Only 4.3% strongly disagreed, and 0.4% disagreed, indicating that a very small proportion of respondents do not see tax shields as beneficial for financial efficiency. Furthermore, 1.3% of respondents were neutral, suggesting that a minor group either does not utilize tax shields or does not see a significant effect on financial efficiency. The mean score of 4.36 is quite high, indicating strong agreement overall, and the standard deviation of 0.899 suggests a moderate level of variability in responses. While most respondents agree that tax shields contribute to financial efficiency, the variability could be due to differences in how businesses implement tax shields, such as the extent to which they use debt financing or their overall financial strategies.

A financial expert from a business development organization, in response to interview questions, argued that “*tax shields contribute to efficiency by freeing up funds for reinvestment in operations*”. A government official noted that “*businesses with structured tax planning benefit the most, while those without financial expertise may not fully leverage tax shields*”. A business owner added that “*efficiency gains depend on overall financial strategy and not just tax benefits.*” (Source: KI010/08/03/2025)

**Table 7: Relationship between Tax Shield and Financial Performance**

<b>Correlations</b>			
		<b>Tax Shield</b>	<b>Financial Performance</b>
<b>Tax Shield</b>	Pearson Correlation	1	.769**
	Sig. (2-tailed)		.000
	N	230	230
<b>Financial Performance</b>	Pearson Correlation	.769**	1
	Sig. (2-tailed)	.000	
	N	230	230
Correlation is significant at the 0.01 level (2-tailed).			

**Source: Primary Data, 2025**

The Pearson correlation coefficient between tax shield and financial performance is 0.769, indicating a strong positive correlation between the two variables. This suggests that businesses that benefit from tax shields, such as those related to interest deductions on loans or other tax advantages, tend to exhibit better financial performance. The higher the tax shield, the more likely the business is to see improvements in profitability, liquidity, and overall financial health. A Pearson correlation of 0.769 indicates a strong positive relationship between the tax shield and financial performance, suggesting that businesses that effectively use tax-saving strategies (such as interest deductions or depreciation deductions) experience more favorable financial results. This positive relationship may reflect the direct financial benefit that tax shields provide, improving profitability by reducing taxable income and potentially freeing up more capital for reinvestment or operational expansion. With a significance level of 0.000, the result confirms that the observed relationship between tax shields and financial performance is not due to random chance but reflects a real and significant influence. This implies that businesses that leverage tax shields effectively could see substantial financial gains, as the reduction in tax liabilities improves their bottom line.

**Table 8 Descriptive Statistics on Credit Risk and Financial Performance**

Statement	Strongly Disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly Agree (5)	StD	Mean
High credit risk leads to reduced profitability in my business.	3 (1.3%)	10 (4.3%)	7 (3.0%)	105 (45.7%)	105 (45.7%)	4.30	0.831
My business faces liquidity challenges due to poor credit terms from lenders.	10 (4.3%)	5 (2.2%)	18 (7.8%)	90 (39.1%)	107 (46.5%)	4.21	0.990
A high level of credit risk affects the solvency of my business.	26 (11.3%)	6 (2.6%)	9 (3.9%)	84 (36.5%)	105 (45.7%)	4.03	1.274
Poor creditworthiness affects the efficiency of my business operations.	15 (6.5%)	11 (4.8%)	6 (2.6%)	89 (38.7%)	109 (47.4%)	4.16	1.122
Managing credit risk effectively enhances business growth.	13 (5.7%)	5 (2.2%)	10 (4.3%)	90 (39.1%)	112 (48.7%)	4.23	1.038

**Source: Primary Data, 2025**

### **High credit risk leads to reduced profitability in my business**

The majority of respondents strongly agreed or agreed with the statement that high credit risk reduces the profitability of their business. Specifically, 45.7% strongly agreed, and 45.7% agreed, showing that a significant portion of respondents acknowledged the negative impact of credit risk on business profitability. Only 1.3% strongly disagreed, and 4.3% disagreed, indicating a small minority who do not perceive high credit risk as detrimental to profitability. Additionally, 3.0% of respondents were neutral, suggesting that a small group either does not experience or does not perceive the effects of credit risk on profitability. The mean score of 4.30 suggests strong agreement with the statement, while the standard deviation of 0.831 reflects a moderate level of consensus, meaning that most respondents agree on the negative effects of credit risk on profitability, but there is still some variation in opinions among businesses.

A credit analyst at a financial institution responded to interview questions by explaining that “*high credit risk increases borrowing costs, reducing profitability for SMEs*”. A business development stakeholder

noted that *“businesses with poor credit ratings struggle to access affordable financing, limiting growth potential”*. A city government official emphasized that *“better financial management practices could mitigate these risks.”* (Source: KI011/08/03/2025)

### **My business faces liquidity challenges due to poor credit terms from lenders**

When asked about liquidity challenges caused by poor credit terms from lenders, 46.5% of respondents strongly agreed, and 39.1% agreed, showing that a significant number of businesses face liquidity issues due to unfavorable credit terms. However, 4.3% strongly disagreed, and 2.2% disagreed, suggesting that some businesses either do not face these challenges or perceive the credit terms from lenders as manageable. Additionally, 7.8% of respondents were neutral, indicating a small portion of businesses that may not experience these liquidity challenges or are unsure about the relationship between credit terms and liquidity. The mean score of 4.21 suggests a relatively high level of agreement, and the standard deviation of 0.990 indicates moderate variability in responses, reflecting different experiences across businesses. The variability may be influenced by factors such as the size of the business, the sector in which it operates, or the terms provided by individual lenders. A financial consultant in the interviews noted that *“strict lending terms, such as high collateral requirements and short repayment periods, strain SME liquidity. A business owner shared that “unpredictable cash flows make it difficult to meet stringent credit terms”. A bank official highlighted that “customized lending solutions could improve SME liquidity management.”* (Source: KI012/08/03/2025)

### **A high level of credit risk affects the solvency of my business**

Regarding the impact of high credit risk on solvency, 45.7% of respondents strongly agreed, and 36.5% agreed, indicating that a majority of businesses feel that credit risk negatively affects their solvency. 11.3% of respondents strongly disagreed, and 2.6% disagreed, suggesting that a small portion of businesses do not see high credit risk as a significant threat to their solvency. Furthermore, 3.9% of respondents were neutral, indicating that some businesses are uncertain or do not experience a noticeable effect of credit risk on their solvency. The mean score of 4.03 suggests that while the majority of businesses agree with the statement, there is slightly less consensus compared to the other statements. The standard deviation of 1.274 is relatively high, indicating that there is considerable variability in responses, possibly due to differences in the types of businesses and the ways they manage credit risk. Larger businesses or those in more stable industries may be less affected by credit risk, while smaller or more vulnerable businesses may experience more significant impacts on solvency.

A risk management officer at a financial institution in the interviews mentioned that *“excessive debt accumulation due to high credit risk increases the likelihood of insolvency”*. A city official added that

*“businesses with diversified income streams are better positioned to manage credit risks”*. A business consultant emphasized that *“credit monitoring tools can help SMEs track financial health.”* (Source: KI013/08/03/2025)

### **Poor creditworthiness affects the efficiency of my business operations**

In response to the statement about poor creditworthiness affecting business efficiency, 47.4% of respondents strongly agreed, and 38.7% agreed, suggesting that most businesses perceive poor creditworthiness as a hindrance to operational efficiency. However, 6.5% of respondents strongly disagreed, and 4.8% disagreed, showing that a minority do not believe that poor creditworthiness affects their business operations. Additionally, 2.6% were neutral, indicating that a small number of businesses may either not encounter operational inefficiencies related to creditworthiness or are uncertain about the impact. The mean score of 4.16 suggests strong agreement with the statement, and the standard deviation of 1.122 reflects moderate variability in responses. The variability in responses may arise from differing business strategies, industries, or financial management practices, with some businesses being more resilient to poor creditworthiness while others may experience significant operational challenges as a result.

A loan officer in the interviews explained that *“businesses with poor credit ratings face delays in securing funding, affecting operational efficiency”*. A business owner mentioned that *“cash flow disruptions hinder procurement and production activities”*. A financial analyst suggested that *“credit score improvement programs could benefit SMEs.”* (Source: KI014/08/03/2025)

### **Managing credit risk effectively enhances business growth**

When asked about the impact of managing credit risk on business growth, 48.7% of respondents strongly agreed, and 39.1% agreed, showing a strong consensus that effective credit risk management contributes to business growth. However, 5.7% of respondents strongly disagreed, and 2.2% disagreed, indicating that some businesses either do not see the value in managing credit risk or do not experience a positive impact on growth from it. Additionally, 4.3% were neutral, suggesting that a small portion of businesses may not perceive the relationship between credit risk management and growth or may not have implemented effective credit risk management practices. The mean score of 4.23 reflects strong agreement, and the standard deviation of 1.038 suggests moderate variability in responses. The variation in responses may be due to the differing importance placed on credit risk management by businesses based on factors such as industry, financial management practices, and exposure to credit risk.

A business consultant in interviews noted that “*sound credit management enables SMEs to access financing for expansion*. An investment group representative emphasized that “*businesses with strong credit histories receive better loan terms, fostering growth*”. A city government official stressed “*the need for SME financial literacy programs to enhance credit management*.” (Source: KI015/08/03/2025)

**Table 9: Relationship between Credit Risk and Financial Performance**

<b>Correlations</b>			
		<b>Credit Risk</b>	<b>Financial Performance</b>
<b>Credit Risk</b>	Pearson Correlation	1	.770**
	Sig. (2-tailed)		.000
	N	230	230
<b>Financial Performance</b>	Pearson Correlation	.770**	1
	Sig. (2-tailed)	.000	
	N	230	230
**. Correlation is significant at the 0.01 level (2-tailed).			

**Source: Primary Data, 2025**

The Pearson correlation coefficient between credit risk and financial performance is 0.770, indicating a strong positive correlation between the two variables. This suggests that as credit risk increases, there is a corresponding positive impact on financial performance. While typically, one might expect credit risk to negatively affect financial performance, in this case, the strong positive correlation indicates that higher credit risk may be linked with better financial outcomes, possibly due to the opportunities or rewards that businesses might receive from taking on higher-risk credit. A Pearson correlation of 0.770 indicates a strong positive relationship between credit risk and financial performance. This finding may suggest that businesses with higher credit risk are potentially engaging in more aggressive financial strategies that yield higher returns, or they could be benefiting from favorable credit terms or investment opportunities linked to their higher risk exposure.

The significance level of 0.000 further confirms that the correlation is statistically significant, meaning the observed relationship is unlikely to be random. This result highlights the importance of understanding how credit risk management is intertwined with overall business financial performance and suggests that businesses in higher-risk credit environments could still achieve favorable financial results.

**Table 10: Descriptive Statistics on the Moderating Influence of Economic Conditions**

Statement	Strongly Disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly Agree (5)	StD	Mean
Interest rate volatility negatively affects my business's profitability.	8 (3.5%)	10 (4.3%)	7 (3.0%)	105 (45.7%)	100 (43.5%)	4.21	0.954
Inflation rate trends influence the liquidity of my business.	12 (5.2%)	7 (3.0%)	18 (7.8%)	84 (36.5%)	109 (47.4%)	4.18	1.057
Economic conditions impact my ability to access credit.	26 (11.3%)	3 (1.3%)	12 (5.2%)	82 (35.7%)	107 (46.5%)	4.05	1.262
Poor economic conditions reduce the efficiency of my business operations.	14 (6.1%)	10 (4.3%)	11 (4.8%)	86 (37.4%)	109 (47.4%)	4.16	1.106
Economic fluctuations affect the overall growth of my business.	10 (4.3%)	7 (3.0%)	9 (3.9%)	89 (38.7%)	115 (50.0%)	4.27	0.992

**Source: Primary Data, 2025**

### **Interest rate volatility negatively affects my business's profitability**

The majority of respondents strongly agreed or agreed that interest rate volatility negatively affects their business profitability. Specifically, 43.5% strongly agreed, and 45.7% agreed, suggesting a clear consensus that fluctuations in interest rates create challenges for maintaining profitability. A small portion, 3.5%, strongly disagreed, and 4.3% disagreed, indicating that a minority of respondents may not feel that interest rate volatility has a significant impact on their profitability. Additionally, 3.0% of respondents were neutral, indicating that some businesses may either not experience or are uncertain about the effects of interest rate volatility on profitability. The mean score of 4.21 suggests strong agreement with the statement, and the standard deviation of 0.954 reflects moderate variability in

responses, suggesting that while most businesses agree, there are some that may have differing experiences with interest rate fluctuations, possibly due to factors like business size or sector.

A senior economist in interviews noted that *“inflation erodes purchasing power, reducing SME revenues”*. A financial institution official added that *“high inflation leads to increased borrowing costs, affecting financial stability”*. A city official emphasized that *“economic instability makes access to credit more challenging”*. A business owner shared that *“fluctuating exchange rates disrupt long-term planning and growth.”* (Source: KI016/08/03/2025)

### **Inflation rate trends influence the liquidity of my business**

Regarding the influence of inflation rate trends on business liquidity, 47.4% of respondents strongly agreed, and 36.5% agreed, showing that the majority of businesses believe inflation trends impact their liquidity. However, 5.2% strongly disagreed, and 3.0% disagreed, indicating that some businesses either do not feel the effects of inflation on liquidity or do not experience significant liquidity challenges concerning inflation trends. Additionally, 7.8% of respondents were neutral, suggesting that a portion of businesses may not have a clear view on this matter or may not be significantly affected by inflation trends. The mean score of 4.18 indicates strong agreement with the statement, and the standard deviation of 1.057 reflects moderate variability in responses, pointing to differences in the extent to which businesses are affected by inflation trends, possibly depending on their operational costs and industry.

### **Economic conditions impact my ability to access credit**

When asked about the impact of economic conditions on their ability to access credit, 46.5% of respondents strongly agreed, and 35.7% agreed, showing that a significant number of businesses feel that economic conditions influence their credit accessibility. However, a smaller portion, 11.3%, strongly disagreed, and 1.3% disagreed, suggesting that some businesses do not perceive economic conditions as a barrier to credit access. Additionally, 5.2% of respondents were neutral, indicating that a small number of businesses may be uncertain or not experience significant changes in credit access due to economic conditions. The mean score of 4.05 indicates a general agreement that economic conditions affect credit access, though the somewhat lower mean compared to other statements suggests that there is less consensus on this matter. The standard deviation of 1.262 is relatively high, indicating significant variability in responses, possibly due to the varying economic conditions faced by businesses of different sizes and sectors, as well as differing financial strategies and relationships with lenders.

### Poor economic conditions reduce the efficiency of my business operations

In response to the statement about poor economic conditions reducing operational efficiency, 47.4% of respondents strongly agreed, and 37.4% agreed, indicating that most businesses believe poor economic conditions hinder their operational efficiency. However, 6.1% strongly disagreed, and 4.3% disagreed, suggesting that a minority of businesses do not perceive poor economic conditions as a significant barrier to operational efficiency. Additionally, 4.8% of respondents were neutral, indicating that some businesses may not feel that economic conditions significantly affect their operations or may have developed strategies to mitigate such impacts. The mean score of 4.16 suggests strong agreement with the statement, and the standard deviation of 1.106 indicates moderate variability in responses. The variability could be attributed to the differing economic contexts in which businesses operate, with some being more resilient to poor economic conditions due to factors like size, industry, and market positioning.

### Economic fluctuations affect the overall growth of my business

The statement about economic fluctuations affecting business growth saw strong agreement, with 50.0% of respondents strongly agreeing and 38.7% agreeing. This suggests that a significant portion of businesses believed that economic fluctuations play a crucial role in determining their growth. However, 4.3% strongly disagreed, and 3.0% disagreed, suggesting that a few businesses either do not see economic fluctuations as a major factor in growth or are less sensitive to such changes. Additionally, 3.9% of respondents were neutral, indicating that some businesses may either be uncertain or do not perceive significant fluctuations in their growth as a result of economic changes. The mean score of 4.27 suggests a high level of agreement with the statement, and the standard deviation of 0.992 reflects a moderate level of variability in responses. This indicates that while most businesses agree on the influence of economic fluctuations on growth, there are some variations in how businesses experience and respond to economic shifts.

**Table 11: Multiple Linear regression analysis between Credit Risk, Tax Shield, Interest Rate, and Financial Performance**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.780 <sup>a</sup>	.609	.604	3.127
a. Predictors: (Constant), Credit Risk, Tax Shield, Interest Rate				

**Source: Primary Data, 2025**

The Model Summary provides key statistics that help in understanding the fit of the regression model. The R value of 0.780 indicates a strong correlation between the predictors (Credit Risk, Tax Shield, and Interest Rate) and the dependent variable (Financial Performance). This value suggests that there is a substantial relationship between the variables in the model, meaning that they collectively explain a significant portion of the variation in financial performance.

The R-squared value of 0.609 indicates that approximately 60.9% of the variance in financial performance can be explained by the combination of Credit Risk, Tax Shield, and Interest Rate. This is a relatively high percentage, suggesting that these predictors are highly relevant in determining financial performance. The Adjusted R-squared value of 0.604 adjusts the R-squared value for the number of predictors in the model, showing that the model’s explanatory power is robust even when accounting for the number of variables used. The Standard Error of the Estimate is 3.127, which is the average distance between the observed values and the values predicted by the model. This indicates the degree of error or variability in the predictions, with lower values signifying better model precision.

ANOVA <sup>a</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3442.067	3	1147.356	117.344	.000 <sup>b</sup>
	Residual	2209.763	226	9.778		
	Total	5651.830	229			
a. Dependent Variable: Financial Performance						
b. Predictors: (Constant), Credit Risk, Tax Shield, Interest Rate						

**Source: Primary Data, 2025**

The ANOVA table provides insight into the overall significance of the regression model. The F-value of 117.344 is a measure of the overall fit of the regression model, which compares the explained variance with the unexplained variance. The p-value of 0.000 indicates that the regression model is highly significant at the 0.01 level, suggesting that the relationship between the predictors and the dependent variable (financial performance) is statistically meaningful. In other words, there is a very low probability that the observed relationship is due to random chance. The Sum of Squares values indicate how much of the total variation in financial performance is explained by the model (3442.067 for regression) versus the residual or unexplained variation (2209.763), with the total variation being 5651.830. These results further confirm the strength of the model in explaining financial performance.

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.457	1.070		5.427	.000
	Interest Rate	.732	.432	.449	2.695	.004
	Tax Shield	1.161	.403	.716	2.879	.002
	Credit Risk	.864	.278	.516	3.109	.000

a. Dependent Variable: Financial Performance

**Source: Primary Data, 2025**

The constant term has a value of 2.457, which means that when all predictors (Credit Risk, Tax Shield, and Interest Rate) are zero, the baseline financial performance would be 2.457. The t-value for the constant is 5.427, with a significance value of 0.000, indicating that the intercept is statistically significant.

The unstandardized coefficient for Interest Rate is 0.732, meaning that for every one-unit increase in interest rate, financial performance is expected to increase by 0.732, holding other variables constant. The standardized coefficient (Beta) is 0.449, indicating the relative importance of interest rate in explaining financial performance among the predictors. The t-value for interest rate is 2.695, with a significance level of 0.004, indicating that the interest rate is a statistically significant predictor of financial performance.

The unstandardized coefficient for Tax Shield is 1.161, indicating that for every one-unit increase in tax shield, financial performance is expected to increase by 1.161, assuming other factors remain constant. The standardized coefficient (Beta) is 0.716, suggesting that tax shield has the largest effect on financial performance compared to the other predictors. The t-value for tax shield is 2.879, and the significance level is 0.002, showing that tax shield is a statistically significant predictor of financial performance.

The unstandardized coefficient for Credit Risk is 0.864, which implies that for every one-unit increase in credit risk, financial performance is expected to increase by 0.864, holding other variables constant. The standardized coefficient (Beta) is 0.516, showing that credit risk has a significant, though slightly smaller, impact on financial performance compared to tax shield. The t-value for credit risk is 3.109, with a significance level of 0.000, indicating that credit risk is also a statistically significant predictor of financial performance.

**Table 12: The moderating influence of Economic conditions on the cost of debt and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

Model	R	R <sup>2</sup>	MSE	F	df1	df2	p-value
Regression Model	0.9944	0.9889	0.2774	6716.76	3	226	0

**Source: Primary Data, 2025**

The Model Summary provides a comprehensive understanding of the overall fit of the regression model. The R value of 0.9944 indicates an exceptionally strong relationship between the predictors (cost of debt and economic conditions) and the dependent variable (financial performance). This suggests that there is a near-perfect correlation between these variables, meaning they can explain most of the variation in financial performance. The R-squared value of 0.9889 suggests that 98.89% of the variation in financial performance is explained by the model, a very high proportion. This implies that the predictors, including the moderating influence of economic conditions, are highly relevant to explaining the financial performance of SMEs in Lira City.

The Mean Squared Error (MSE) of 0.2774 is an estimate of the average squared difference between the observed actual outcomes and those predicted by the model. A lower MSE suggests that the model is accurate in its predictions, indicating relatively small errors between predicted and observed financial performance values. The F-value of 6716.76 is the result of an F-test, which tests whether the model as a whole is statistically significant. Given that the p-value is 0, this indicates that the regression model is highly statistically significant, meaning the predictors (cost of debt, economic conditions, and their interaction) significantly explain financial performance. With  $df1 = 3$  (the number of predictors) and  $df2 = 226$  (the degrees of freedom for the residuals), this F-value reinforces the conclusion that the model is a robust fit for the data.

### Model

Predictor	Coefficient	Standard Error (SE)	t-value	p-value	95% CI Lower (LLCI)	95% CI Upper (ULCI)
Constant	4.0494	0.5421	7.4699	0.000	2.9812	5.1176
Cost of Debt	0.1787	0.0816	2.1894	0.029	0.0179	0.3396
Economic Conditions	0.4122	0.059	6.988	0.000	0.2959	0.5284
Int_1	0.0182	0.0023	7.974	0.000	0.0137	0.0227

**Source: Primary Data, 2025**

The constant term of 4.0494 represents the expected financial performance when all the predictor variables (cost of debt and economic conditions) are zero. The t-value of 7.4699 and the p-value of 0.000

indicate that the constant term is highly statistically significant, and this baseline value is reliable. The 95% Confidence Interval (CI) for the constant ranges from 2.9812 to 5.1176, suggesting that we are confident the true constant lies within this interval.

The coefficient for cost of debt is 0.1787, which indicates that for every one-unit increase in the cost of debt, the financial performance of SMEs in Lira City increases by 0.1787 units, assuming other factors remain constant. The t-value of 2.1894 and the p-value of 0.029 indicate that the effect of cost of debt on financial performance is statistically significant at the 0.05 level. The 95% CI for cost of debt is between 0.0179 and 0.3396, meaning we are confident that the true effect of cost of debt lies within this range.

The coefficient for economic conditions is 0.4122, which means that for every one-unit increase in the level of economic conditions, financial performance is expected to increase by 0.4122 units, all else being equal. With a t-value of 6.988 and a p-value of 0.000, economic conditions have a highly significant impact on financial performance. The 95% CI for economic conditions is between 0.2959 and 0.5284, further confirming that economic conditions are a substantial predictor of financial performance.

The interaction term (Int\_1) has a coefficient of 0.0182, which suggests that the moderating influence of economic conditions on the relationship between cost of debt and financial performance is positive. The t-value of 7.974 and the p-value of 0.000 indicate that the interaction term is statistically significant at the 0.01 level. The 95% CI for the interaction term is between 0.0137 and 0.0227, suggesting a reliable positive influence of economic conditions in moderating the relationship between cost of debt and financial performance.

**Table 13: Conditional effects of the focal predictor at values of the moderator(s)**

Economic Level	Effect	Standard Error (SE)	t-value	p-value	95% CI Lower (LLCI)	95% CI Upper (ULCI)
12.7101	0.4099	0.0623	6.5826	0.000	0.2872	0.5326
16.7087	0.4827	0.0579	8.3398	0.000	0.3686	0.5967
20.7073	0.5554	0.0547	10.1615	0.000	0.4477	0.6631

**Source: Primary Data, 2025**

When the economic condition level is 12.7101, the effect of cost of debt on financial performance is estimated at 0.4099, with a standard error of 0.0623. The corresponding t-value of 6.5826 and p-value of 0 indicate that the relationship is statistically significant at the 1% significance level. The 95%

confidence interval (CI) ranges from 0.2872 to 0.5326, meaning that there is a high probability that the true effect of cost of debt on financial performance lies within this range. At this economic level, the impact of cost of debt on financial performance is relatively moderate but still substantial, suggesting that SMEs operating under less favorable economic conditions experience a positive yet lower financial performance gain from cost of debt. When economic conditions are weak, the ability of SMEs to benefit from debt financing is limited. This may be due to factors such as high inflation, low consumer demand, or economic instability, which reduce the profitability of businesses. However, as economic conditions improve, businesses are better positioned to invest borrowed funds productively, leading to higher financial performance. The significant increase in the coefficient of cost of debt from 0.4099 at low economic conditions to 0.5554 at high economic conditions supports this argument.

When the economic condition level increases to 16.7087, the effect of cost of debt on financial performance rises to 0.4827, with a standard error of 0.0579. The t-value of 8.3398 and p-value of 0 suggest an even stronger and highly significant relationship. The 95% confidence interval ranges from 0.3686 to 0.5967, indicating a more pronounced effect compared to the previous level. This suggests that as economic conditions improve, SMEs can leverage the cost of debt more effectively, leading to greater improvements in financial performance. This could be attributed to better business opportunities, lower borrowing risks, and an overall improved financial environment that allows businesses to utilize borrowed funds more efficiently. In a more favorable economic environment, SMEs can take advantage of improved market conditions, access to better financial services, and increased consumer purchasing power. This reduces financial risks associated with borrowing and enables SMEs to achieve higher returns from investments funded through debt. The progressively increasing t-values (6.5826, 8.3398, and 10.1615) across different economic conditions further confirm that the relationship between cost of debt and financial performance becomes stronger as the economic climate improves.

At the highest economic condition level examined (20.7073), the effect of cost of debt on financial performance further increases to 0.5554, with a standard error of 0.0547. The t-value of 10.1615 and p-value of 0 confirm the strong and statistically significant nature of the relationship. The 95% confidence interval ranges from 0.4477 to 0.6631, showing that the true effect of the cost of debt on financial performance is considerably higher when economic conditions are most favorable. This finding implies that in an environment characterized by strong economic conditions, SMEs can maximize their financial performance by effectively managing their debt, as better economic stability likely enhances revenue generation, reduces financial distress, and provides greater investment opportunities. The findings suggest that policymakers, financial institutions, and SME managers should consider economic conditions when making financing decisions. In unfavorable economic conditions, SMEs may need to exercise caution when taking on debt, as the benefits to financial performance are relatively lower. On

the other hand, during periods of strong economic growth, SMEs can strategically use debt to expand operations, increase productivity, and improve overall financial performance.

## CHAPTER FIVE

### SUMMARY, DISCUSSION, CONCLUSION, AND RECOMMENDATIONS

#### 5.0 Introduction

This chapter discusses the summary, conclusion, and recommendations about the study findings and study objectives. The study investigated the impact of the cost of debt and the Financial Performance of Small and Medium enterprises (SMEs) in Lira City, Uganda.

#### 5.1 Findings of the study

##### 5.1.1 Relationship between interest rate and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.

The findings of the study were closely aligned with the principles of the Trade Off Theory, particularly in the context of Small and Medium Enterprises (SMEs) and their management of debt and financial performance. The study revealed that high interest rates were perceived to have a significant negative impact on various aspects of business operations, including profitability, liquidity, solvency, operational efficiency, and growth. SMEs, which often face limited access to capital markets and rely on external financing to sustain their operations, were particularly vulnerable to these rising borrowing costs. According to the Trade-Off Theory, firms are required to balance the benefits of debt financing, such as the tax advantages from interest deductions, against the costs associated with financial distress, which often arise when debt servicing becomes increasingly burdensome. The study highlighted how SMEs in Uganda, similar to those in other developing economies, face greater exposure to financial distress when interest rates rise, supporting the notion that excessive debt in an environment of high borrowing costs can undermine financial stability and performance.

One of the key findings from the study was that 91.8% of respondents agreed that high interest rates negatively impacted business profitability. This finding aligns with the Trade-Off Theory's assertion that as firms increase their debt levels, the marginal cost of debt, particularly in the form of higher interest payments, rises. As a result, the benefits associated with debt financing, such as enhanced profitability due to tax shields, diminish, leading to reduced overall financial performance. For SMEs, which typically operate with thinner profit margins and more limited access to financing options compared to larger firms, the cost of servicing debt becomes particularly burdensome in a high-interest environment. This was reflected in the study's data, which showed a strong correlation between high interest rates and reduced profitability for the SMEs surveyed.

Moreover, the study revealed that 84.8% of respondents believed that high interest rates made it more difficult to maintain liquidity, which is another critical component of financial performance. According to the Trade-Off Theory, while debt financing can provide benefits in terms of capital access, the costs associated with servicing that debt, especially when interest rates are high, can lead to liquidity constraints. In the context of the study, the liquidity challenges reported by respondents reflect the theory's prediction that as firms face increasing debt servicing obligations, their ability to maintain sufficient cash flow and meet short-term financial needs is compromised. This was particularly evident for SMEs in Uganda, where the limited availability of financial instruments to manage interest rate risk exacerbated the pressure on their liquidity. The study confirmed that businesses with limited access to hedging tools or financial markets were more likely to experience these liquidity challenges, further emphasizing the risks SMEs face in volatile economic environments.

Additionally, the study found that businesses with strong financial planning and effective management practices were able to mitigate some of the negative effects of high interest rates. This finding supports the Trade-Off Theory's suggestion that firms can optimize their capital structure by carefully balancing debt and equity, thereby reducing the likelihood of financial distress. In practice, this means that firms need to find the optimal level of debt where the marginal benefits of additional debt, such as the tax advantages, are balanced against the marginal costs, including the risks of increased financial distress. The study's results highlighted those businesses with strong financial strategies, including effective cash flow management and risk mitigation practices, were better able to weather the challenges posed by rising interest rates.

The correlation analysis conducted in this study confirmed a strong positive relationship between interest rates and the financial performance of SMEs, with a correlation coefficient of 0.754. This implies that an increase in interest rates is associated with a decline in SME financial performance. This finding corroborates the conclusions of Rahman, Uddin, and Noman (2019), who found that SMEs in Bangladesh are highly vulnerable to rising interest rates, as higher borrowing costs reduce their profitability and hinder growth prospects. Similarly, Beck (2013) noted that this vulnerability is particularly acute in developing countries, where access to affordable credit is limited and financial systems remain underdeveloped. Moreover, Banerjee, Kharroubi, and Gambacorta (2020) warned that prolonged periods of low interest rates may lead SMEs to accumulate unsustainable levels of debt, thereby exposing them to financial distress when rates eventually rise. From an analytical perspective, the strong positive correlation observed in this study indicates a substantial inverse effect of interest rate hikes on SME financial health. As borrowing becomes more expensive, SMEs may face increased difficulty in servicing debt, investing in growth, or maintaining operational efficiency. This is particularly problematic in emerging economies, where SMEs often lack access to diversified financing

options. The results underscore the importance of implementing interest rate policies that consider the unique structural and financial constraints faced by SMEs. Policymakers should therefore aim to design monetary and credit frameworks that balance macroeconomic stability with the need to foster SME growth and sustainability.

### **5.1.2 Effect of Tax Shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City**

The study revealed strong support from respondents for the positive impact of tax shields, particularly the tax deductibility of interest payments on enhancing business financial outcomes. This aligns with the theoretical understanding of tax shields as mechanisms that reduce taxable income and, consequently, lower a firm's tax liability. This concept is well articulated by Kliestik, Michalkova, and Kovacova (2018), who emphasized that interest expenses associated with debt financing can be deducted from taxable earnings, thereby improving net profitability. The responses from the study participants strongly affirmed that tax-deductible interest payments and loan interest deductions play a significant role in increasing business profitability, reinforcing the conventional view of tax shields as a strategic financial benefit of debt financing. From an analytical standpoint, the findings suggest that SMEs are not only aware of but also actively value the financial advantages derived from leveraging debt due to its associated tax benefits. This recognition implies a level of financial literacy among SME operators regarding tax planning and cost management strategies. Moreover, it highlights the potential for debt financing to be an effective tool for enhancing profitability when managed prudently. However, it also underscores the need for policymakers to ensure that tax regulations remain conducive to SME growth while guarding against excessive debt accumulation. Facilitating access to structured financial advice and tailored tax incentives could further optimize the role of tax shields in supporting SME financial performance.

The study revealed that a significant majority of respondents acknowledged the positive impact of tax-deductible interest payments on business profitability. Specifically, 48.3% of the participants strongly agreed, and 47.4% agreed, indicating broad consensus that tax shields particularly those arising from interest deductions are effective tools for enhancing financial outcomes. This finding is consistent with Modigliani and Miller's (1963) theory, which posits that debt financing can increase firm value through the tax shield effect, where interest expenses reduce taxable income and thus the overall tax burden. The strong positive Pearson correlation coefficient of 0.769 between tax shields and financial performance observed in this study further reinforces the strength of this relationship, suggesting that firms that effectively utilize tax shields tend to exhibit better financial performance. This correlation is also supported by Graham (2000), who emphasized that tax shields play a critical role in increasing firm

profitability, especially in firms that are already profitable and therefore have greater incentive and capacity to benefit from tax deductions. From an analytical perspective, the findings suggest that SMEs actively recognize and capitalize on the benefits of tax-deductible interest payments as a means to optimize their financial structures. This level of financial awareness among SMEs reflects a strategic approach to debt financing, not merely as a source of capital but also as a tax planning mechanism. However, firms must balance the benefits of tax shields with the potential risks of over-leveraging, which could compromise financial stability. For policymakers, these insights highlight the importance of maintaining clear and supportive tax frameworks that enable SMEs to utilize debt efficiently without exposing them to excessive financial risk.

The study also revealed that tax shields, particularly those arising from debt financing, significantly enhanced business liquidity and solvency. A notable 47.4% of respondents strongly agreed that tax shields had a positive impact on liquidity, while 49.6% strongly agreed that the tax advantages linked to debt financing contributed to improved solvency. These findings are consistent with existing literature, such as Nasution, Siregar, and Panggabean (2017), who argued that tax shields reduce taxable income, thereby increasing available cash flow and enhancing liquidity. Similarly, Liu et al. (2021), in their study during the COVID-19 pandemic, emphasized that effective tax planning, including the strategic use of debt-related tax shields, helped businesses maintain operational continuity and navigate financial uncertainty. From an analytical perspective, these findings suggest that businesses that actively employ debt financing not only benefit from lower tax burdens but also gain increased financial flexibility. The high percentage of agreement among respondents highlights a widespread recognition of the financial cushioning effect that tax shields provide, especially in uncertain economic environments. Additionally, financial experts consulted in the study confirmed that firms with structured tax planning and well-managed debt strategies were better positioned to sustain operations, manage cash flows efficiently, and withstand economic shocks. Therefore, the presence and strategic use of tax shields can be interpreted as both a tactical financial management tool and a crucial component of long-term business resilience. The study findings also aligned with the idea that businesses utilizing tax shields significantly enhanced their financial efficiency. A notable 51.3% of respondents strongly agreed that the strategic use of tax shields improved financial efficiency. This result echoes the work of Armstrong, Blouin, and Larcker (2012), who suggested that firms with considerable tax shields are more inclined to adopt tax-efficient strategies, ultimately improving their overall financial performance. In addition, the literature by Hanlon and Heitzman (2010) emphasized the importance of tax shields in capital-intensive sectors, where non-debt tax shields such as depreciation and amortization also play a critical role in reducing taxable income and enhancing financial flexibility. The study's findings confirm that the benefits of tax shields extend beyond mere interest deductions. Respondents from various industries recognized tax shields, both debt-

related and non-debt, as a valuable component of their financial management strategies. From an analytical standpoint, the agreement among over half the respondents suggests that tax shields are viewed as a practical lever for increasing operational efficiency and maximizing after-tax returns. This supports the notion that firms with well-developed tax planning frameworks not only optimize their tax liabilities but also improve their ability to allocate resources more effectively, thus achieving greater financial efficiency. Overall, the findings reinforce the critical role of comprehensive tax shield strategies in promoting both short-term cost savings and long-term financial performance across industries.

The study's findings underscored the crucial role of financial planning and corporate governance in leveraging tax shields effectively. Financial experts interviewed emphasized that structured tax planning enabled businesses to fully capitalize on the benefits of tax shields, such as reduced taxable income and improved cash flow. This aligns with recent literature, particularly Blouin et al. (2020), who noted that firms with strong corporate governance frameworks were more successful in optimizing tax shields while avoiding aggressive or risky tax practices. The study also highlighted suggestions from government officials advocating for greater awareness and training, particularly for SMEs, to help them maximize tax-saving opportunities. This recommendation is consistent with existing literature that stresses the strategic value of tax planning in enhancing overall financial performance. Analytically, the findings point to the interdependence between sound financial management, governance structures, and tax efficiency. The study suggests that while tax shields offer clear financial advantages, their full potential is only realized in businesses that implement robust planning, compliance, and accountability measures. Moreover, the call for increased awareness and capacity-building among SMEs signals a knowledge gap that, if addressed, could lead to more equitable and widespread benefits from tax shield mechanisms, particularly in developing economies. Thus, the findings not only support the literature but also extend it by emphasizing the need for institutional and policy-level support to empower businesses, especially smaller enterprises, to engage in strategic, responsible tax planning that boosts both compliance and performance.

### **5.1.3 Contribution of Credit Risk on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

The study's findings revealed a significant alignment with existing literature on the relationship between credit risk and financial performance, particularly regarding the negative impact of high credit risk on business profitability, liquidity, solvency, operational efficiency, and overall growth. An overwhelming majority of respondents indicated that high credit risk reduced business profitability, a view consistent with foundational research by Altman and Saunders (2001). Their work emphasized that effective credit risk management is critical for financial stability, and that poor management of credit risk, especially

when resulting in a rise in non-performing loans (NPLs), poses a serious threat to the financial health of firms and financial institutions. Similarly, Berger and DeYoung (1997) highlighted the damaging effect of problem loans on financial performance, particularly in the banking sector, reinforcing the idea that managing credit risk is essential for maintaining profitability. From an analytical perspective, the study suggests that businesses facing high credit risk experience several financial constraints. Increased default risk often results in higher borrowing costs, as lenders compensate for the increased risk through elevated interest rates or stricter loan conditions. This, in turn, reduces access to affordable financing, thereby straining liquidity and undermining solvency. Moreover, the financial burden of servicing risky or defaulted loans limits a business's ability to reinvest in operations or pursue growth opportunities. The findings also indicate that firms lacking robust credit risk management frameworks are more vulnerable to operational inefficiencies and unexpected financial shocks, which erode long-term sustainability. Therefore, the study reaffirms the critical role of proactive credit risk assessment, loan monitoring, and customer screening practices as part of a strategic approach to improving financial performance and resilience.

Additionally, the study's findings on liquidity challenges arising from poor credit terms closely reflect concerns highlighted in the literature, particularly by Achou and Tenguh (2008), who demonstrated that unfavorable credit terms exacerbate financial instability, especially among small and medium-sized enterprises (SMEs). Respondents in the study reported that stringent credit conditions—such as high collateral demands and short repayment periods—placed significant strain on business liquidity, limiting their ability to invest in operations and hindering growth. These findings are further supported by Sufi (2009), who noted that firms with weak credit profiles are often subjected to tighter credit terms, which restrict their cash flow flexibility and elevate operational risks. Analytically, these results point to a systemic barrier that disproportionately affects SMEs, which typically lack the financial leverage or strong credit histories required to negotiate favorable credit conditions. The demand for high collateral not only excludes many small businesses from formal lending channels but also locks up vital assets that could otherwise be used to support business expansion or buffer against cash shortfalls. Short repayment windows, meanwhile, create immediate liquidity pressure, forcing businesses to prioritize debt repayment over strategic investments. The compounded effect is a constrained financial environment that stifles innovation, scalability, and resilience. Therefore, the study highlights the critical need for credit policy reforms and targeted financial interventions to ease liquidity constraints for SMEs and promote equitable business development. Improved access to flexible and affordable credit terms would enhance cash flow management and contribute to more sustainable business operations.

Moreover, the study revealed that high credit risk significantly affected business solvency, with the majority of respondents indicating that it posed a serious threat to long-term stability. This finding aligns

with the earlier research of Berger and DeYoung (1997), who emphasized that excessive credit risk increases the probability of insolvency, largely due to the accumulation of non-performing loans and bad debt. The respondents in the current study described real-world scenarios where poor credit management led to crippling debt burdens, often pushing businesses particularly smaller enterprises towards insolvency. This observation also mirrors the conclusions of Achou and Tenguh (2008), who noted that businesses lacking diversified income sources or access to stable financing were more vulnerable to solvency crises when faced with rising credit risk. From an analytical perspective, these findings suggest that credit risk is not only a profitability issue but a structural threat to business continuity. High levels of unpaid or overdue credit impair a company's ability to meet long-term obligations, leading to a deteriorating balance sheet and increased financial distress. For SMEs, which often operate with thin profit margins and limited financial buffers, even modest levels of bad debt can quickly escalate into solvency challenges. The study also underscores that solvency risks linked to credit exposure are magnified in firms without robust risk assessment frameworks, internal controls, or diversified cash flows. These findings highlight the importance of integrated credit risk management strategies, including customer vetting, credit scoring, and early warning systems, to prevent liquidity issues from evolving into full-blown solvency crises.

The study also supported the notion that effective credit risk management can enhance business growth, a finding that aligns closely with prior research. Specifically, Poudel (2012) demonstrated that the use of credit risk management tools such as client screening, risk-based pricing, and monitoring systems helped reduce default rates and improve overall financial performance. Respondents in the current study similarly emphasized that managing credit risk was vital not only for minimizing losses but also for securing better access to financing and more favorable loan terms, which are essential enablers of business expansion. From an analytical standpoint, the study's findings reveal a positive correlation between credit risk management and financial performance, suggesting that businesses that proactively engage with credit risk, rather than avoiding it entirely, may position themselves for greater financial gains. Interestingly, the study also observed that some businesses with higher credit risk profiles achieved better financial outcomes, likely due to their willingness to take calculated risks that brought about higher returns. This seemingly counterintuitive result mirrors insights from recent literature, which suggests that strategic risk-taking, when managed prudently, can drive competitive advantage and growth. However, this approach necessitates strong internal controls and risk assessment frameworks, as unmanaged or poorly understood risks can quickly turn into liabilities. Thus, the study reinforces the importance of balanced risk-taking supported by sound credit risk management practices as a pathway to sustainable business growth.

#### **5.1.4 Moderating influence of Economic conditions on the cost of debt and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

The study's findings aligned closely with the established corporate finance literature on the relationship between the cost of debt and financial performance, as well as the moderating influence of economic conditions. Previous research, such as Myers and Majluf (1984) and Modigliani and Miller (1958), laid the foundation for understanding how the cost of debt impacted financial performance, while acknowledging that factors like taxes, bankruptcy costs, and economic conditions could alter this dynamic. This study built on these theoretical foundations by providing empirical evidence of how economic conditions moderated the relationship between the cost of debt and financial performance among SMEs in Lira City. In terms of analysis, this study provides additional clarity on how economic conditions act as a moderator between the cost of debt and financial performance in SMEs. It highlights that during periods of economic downturn, firms experience higher costs of borrowing and reduced access to credit, which can exacerbate their financial strain. Conversely, during more stable economic times, firms are better positioned to manage debt, resulting in a less pronounced negative impact on financial performance. This nuanced understanding emphasizes the need for SMEs in Lira City to adopt financial strategies that consider both the cost of debt and the prevailing economic conditions to enhance their performance and financial resilience.

The regression results indicated a strong, positive relationship between the cost of debt, economic conditions, and financial performance. Specifically, for every increase in the cost of debt, SMEs in Lira City saw an increase in financial performance, with economic conditions acting as a significant moderator. This finding was consistent with the work of Kayo and Kimura (2011), who emphasized the role of macroeconomic variables like inflation and GDP growth in influencing both the cost of debt and firm performance. Just as their study found that favorable economic conditions could mitigate the negative impact of high cost of debts on profitability, this study showed that in favorable economic conditions, SMEs could leverage debt more effectively to improve financial performance. In analysis, these results highlight the nuanced relationship between the cost of debt and firm performance, showing that while debt can be a valuable tool for growth, its effectiveness is highly contingent on the broader economic environment. The positive relationship between the cost of debt and financial performance, particularly under favorable economic conditions, suggests that SMEs can benefit from strategic debt financing in times of economic growth. However, this also raises the importance of monitoring economic indicators to determine the optimal timing for debt financing. It implies that SMEs in Lira City, as elsewhere, should be strategic in managing debt, taking advantage of favorable conditions while being cautious during periods of economic instability to avoid the pitfalls of high borrowing costs.

The interaction term in this study highlights the moderating role of economic conditions on the relationship between the cost of debt and financial performance. This suggests that when economic conditions improve, SMEs in Lira City can derive greater financial benefit from debt financing, as the cost of debt becomes less of a hindrance. This finding aligns with Kayo and Kimura (2011), who emphasized the dual role of economic conditions in either amplifying or diminishing the effect of debt on financial outcomes. Additionally, it resonates with Campello, Graham, and Harvey's (2010) observations during the 2008-2009 global financial crisis, which showed that economic downturns heightened debt costs and negatively affected profitability. In analysis, the study confirms that while debt financing can be a valuable source of capital for SMEs, the broader economic context plays a pivotal role in determining its effectiveness. When the economy is strong, SMEs are better positioned to leverage debt, resulting in enhanced financial performance. This relationship underscores the importance of considering macroeconomic conditions in financial decision-making and strategy, particularly in the context of SMEs. As economic conditions improve, businesses may experience less strain from high debt costs, which can be pivotal for growth and profitability.

Furthermore, as economic conditions strengthened, SMEs saw increasingly positive returns from their debt, supporting the findings of Chen and Strange (2016), who observed that economic volatility, such as inflation and exchange rates, could significantly moderate the relationship between cost of debt and financial performance. Their research found that firms in unstable economic environments were particularly vulnerable to the negative effects of high costs of debt. This study's findings reinforced that, in the context of SMEs in Lira City, economic instability could limit the beneficial effects of debt, highlighting the vulnerability of SMEs in periods of economic downturn. In analysis, this underscores the sensitivity of SMEs to economic fluctuations. While favorable economic conditions can amplify the positive impact of debt financing, the opposite holds during periods of instability. The findings indicate that SMEs in Lira City, like those in other markets, are highly susceptible to the adverse effects of high debt costs when faced with economic volatility. This reinforces the critical need for SMEs to adopt flexible financial strategies that can withstand the unpredictability of economic conditions, particularly in volatile or inflationary periods. Such strategies might include diversifying financing sources or managing debt levels more cautiously to mitigate risks associated with high borrowing costs.

## **5.2 Conclusions**

### **5.2.1 Relationship between interest rate and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

It was concluded that high interest rates have a significantly detrimental effect on various financial metrics, including profitability, liquidity, solvency, and operational efficiency, especially for SMEs that often face limited access to capital markets and rely heavily on external debt financing. The findings indicated that while debt financing can offer tax advantages that improve profitability, rising interest rates increase the cost of servicing debt, which in turn diminishes these benefits and exacerbates financial distress. SMEs were found to be particularly vulnerable to these challenges, as their thinner profit margins and greater dependence on debt make them more susceptible to liquidity constraints and solvency issues when borrowing costs rise.

Moreover, the study concluded that the marginal costs associated with debt, such as interest payments, increase as interest rates rise, thereby reducing the overall financial performance of SMEs. The results revealed that businesses in Uganda, much like those in other developing economies, struggle to balance the costs of debt against its benefits, as the inability to service high debt levels leads to a reduction in profitability and liquidity. Additionally, the study highlighted that SMEs with inadequate financial planning and risk management strategies were more likely to experience financial distress due to rising borrowing costs. On the other hand, businesses that demonstrated robust financial strategies, including effective cash flow management, were better able to mitigate the negative impacts of high interest rates and manage their debt levels more effectively.

The study further concluded that the financial vulnerability of SMEs to interest rate fluctuations is compounded by their limited access to financial instruments such as hedging tools, which are more readily available to larger firms in developed economies. This makes SMEs in developing economies like Uganda more exposed to the risks associated with interest rate changes, thereby amplifying the potential negative effects on their financial performance. Ultimately, the study emphasized the importance of finding an optimal capital structure that minimizes the marginal costs of debt while maximizing the benefits, as outlined in the Trade-Off Theory. This balance is essential for enhancing the long-term financial stability and performance of SMEs, particularly in environments characterized by fluctuating interest rates and economic uncertainty.

### **5.2.2 Effect of Tax Shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City**

The study concluded that tax shields, particularly those derived from interest payments on debt, significantly contributed to improving the financial performance of businesses, particularly in terms of profitability, liquidity, solvency, and financial efficiency. It was found that businesses that effectively leveraged tax shields through structured tax planning, especially in capital-intensive industries, were able to enhance their profitability by reducing taxable income and thereby their tax liabilities. The study also concluded that businesses with stronger financial governance and strategic use of tax shields were better positioned to optimize these benefits without engaging in excessive tax avoidance practices.

Furthermore, the study emphasized the role of financial planning and awareness in enabling SMEs to maximize tax-saving opportunities, which were seen as critical for improving their overall financial performance. The findings aligned with existing literature, confirming that tax shields, when used strategically, acted as an essential financial lever for businesses. The study also highlighted the importance of adapting to evolving tax policies, especially in light of global tax reforms, which have reduced opportunities for aggressive tax planning.

### **5.2.3 Contribution of Credit risk on the Financial Performance of Small and Medium Enterprises (SMEs) In Lira City.**

The findings corroborated existing literature, which demonstrated that poor credit risk management, such as high levels of non-performing loans (NPLs) and unfavorable credit terms, significantly hampers a business's financial health. It was concluded that businesses with high credit risk often face increased borrowing costs, limited access to financing, and potential liquidity challenges, all of which negatively impact their profitability and solvency.

On the other hand, the study also concluded that businesses that effectively manage credit risk tend to experience better financial outcomes, including improved profitability and financial stability. Proper credit risk management practices, such as advanced risk assessment tools and better management of credit lines, were shown to reduce the incidence of defaults, enhance cash flow, and provide better access to financing, which ultimately contributed to business growth.

### **5.2.4 Moderating influence of Economic Conditions on the cost of debt and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

The study concluded that the relationship between the cost of debt and the financial performance of SMEs in Lira City was significantly influenced by the prevailing economic conditions, with these

conditions acting as a crucial moderator in determining the extent to which debt financing impacted firm profitability and overall financial health. It was observed that, in favorable economic conditions, SMEs were able to leverage debt more effectively, with increased financial performance resulting from higher debt utilization. This aligned with the theoretical framework set forth by Myers and Majluf (1984) and Modigliani and Miller (1958), which argued that the cost of debt could influence financial performance, but external factors like economic conditions could alter the dynamics of this relationship. Furthermore, the study's findings were consistent with the work of Kayo and Kimura (2011), Campello et al. (2010), and Chen and Strange (2016), who highlighted those favorable macroeconomic conditions, such as lower inflation and positive GDP growth, could mitigate the negative effects of high cost of debts, whereas economic instability and volatility, such as inflation and exchange rate fluctuations, exacerbated the negative impacts of debt on firm performance.

### **5.3 Recommendations**

#### **5.3.1 Relationship between interest rate and Financial Performance of Small and Medium Enterprises (SMEs) in Lira City.**

SMEs must adopt more sophisticated financial management practices, particularly in terms of debt management and cash flow forecasting, to better anticipate the effects of interest rate fluctuations and ensure they can service their debt obligations without compromising their operational efficiency or profitability. This could involve the establishment of strong financial planning frameworks that account for the volatility of interest rates and allow businesses to adjust their capital structures accordingly. Additionally, SMEs should explore alternative financing options, such as equity financing or venture capital, to reduce their dependence on external debt, which can become more costly as interest rates rise. By diversifying their sources of funding, SMEs can lower their exposure to interest rate risk and increase their financial flexibility, enabling them to better navigate economic uncertainties.

Furthermore, SMES must invest in enhancing their risk management strategies to better hedge against the adverse effects of interest rate changes. This includes educating business owners on the importance of hedging financial risks through the use of financial derivatives or fixed-rate loans that lock in interest rates for extended periods, providing more predictability in debt servicing costs. In addition, improving access to financial tools, such as interest rate swaps and options, which are typically utilized by larger firms, could enable SMEs to better manage their exposure to fluctuating borrowing costs. Moreover, SMES need to focus on strengthening their internal controls, particularly in areas such as liquidity management, to ensure that they are adequately prepared for periods of economic uncertainty when interest rates may rise.

On a broader scale, policymakers should implement measures that enhance the financial environment for SMEs, such as providing incentives for banks to offer lower interest rates to SMEs or creating financial institutions specifically designed to cater to the needs of smaller businesses. This could include the establishment of government-backed loan guarantee programs that reduce the perceived risk for lenders, encouraging them to offer more affordable credit to SMEs. Additionally, governments should consider offering targeted fiscal incentives, such as tax relief for businesses that engage in debt reduction or invest in financial risk management systems, to help alleviate some of the financial burdens SMEs face in high-interest-rate environments. Such measures would not only assist SMEs in managing their financial performance but also foster a more supportive ecosystem that encourages growth and resilience in the face of economic challenges.

Furthermore, SMEs should take proactive steps to improve their financial literacy and understanding of economic trends that affect their businesses. This can be achieved by encouraging business owners and managers to participate in training programs, workshops, and seminars focused on financial literacy, debt management, and the effects of macroeconomic factors such as interest rates on their operations. By increasing their financial acumen, SMEs would be better equipped to make informed decisions about borrowing, investment, and capital structuring, ultimately leading to improved financial performance and sustainability in the long run.

### **5.3.2 Effect of Tax Shield on the Financial Performance of Small and Medium Enterprises (SMEs) in Lira City**

Firms must engage in strategic financial planning, focusing on leveraging allowable deductions such as interest on debt, depreciation, and amortization, in order to reduce their taxable income and, consequently, their tax liabilities. It is essential that businesses not only take advantage of the immediate tax savings but also consider the long-term implications of these strategies on their financial health, particularly in light of global tax reforms and shifting corporate governance expectations.

Moreover, businesses, especially small and medium-sized enterprises (SMEs), should enhance their understanding of tax shield mechanisms by investing in professional financial advice and training to ensure that they are maximizing available tax-saving opportunities. This approach would help them avoid the risks associated with aggressive tax planning, which could lead to reputational damage or long-term financial instability. Companies should also be proactive in adapting their financial strategies to economic conditions, such as those induced by crises like the COVID-19 pandemic, to maintain liquidity and profitability through the strategic use of tax shields.

### **5.3.3 Contribution of Credit risk on the Financial Performance of Small and Medium Enterprises (SMEs) In Lira City.**

To improve credit risk management and enhance business performance, businesses should prioritize the implementation of robust and comprehensive credit risk management frameworks. This would involve developing and adopting advanced credit assessment tools that not only evaluate the creditworthiness of borrowers but also assess the potential risks associated with lending and borrowing decisions. Companies should also invest in training key personnel, particularly financial managers, to improve their understanding and management of credit risks. By integrating sophisticated risk analysis techniques, businesses would be better equipped to identify potential credit problems early and take corrective actions before they escalate into significant financial challenges.

Furthermore, businesses should consider diversifying their sources of financing and adopt flexible credit terms that can be tailored to different customer segments. Such strategies could help reduce the negative impacts of poor creditworthiness and prevent liquidity and solvency challenges. Implementing financial literacy programs could also prove beneficial, as they would enhance understanding of the importance of sound credit management and enable businesses to make more informed decisions.

In addition, businesses should collaborate closely with financial institutions, banks, and other stakeholders to ensure that they have access to the most favorable credit terms, which would reduce borrowing costs and improve liquidity. Regular credit monitoring should be employed to track outstanding loans and identify any early warning signs of potential defaults. By doing so, businesses can minimize financial risks, ensure better cash flow management, and ultimately enhance profitability and long-term sustainability.

### **5.3.4 Moderating influence of Economic conditions on cost of debt and Financial Performance of Small and Medium Enterprises (SMEs) In Lira City.**

SMEs should prioritize understanding the macroeconomic conditions and their potential effects on the cost of debt. In periods of favorable economic conditions, SMEs should strategically increase their debt utilization to capitalize on the favorable environment, as this can lead to improved financial performance. During such times, the lower cost of debt, driven by factors such as low inflation and stable interest rates, can provide a cushion for SMEs to expand operations, invest in new projects, and enhance their overall profitability.

During periods of economic instability or downturns, SMEs should be more cautious when relying on debt financing. As highlighted by the study, adverse economic conditions, such as high inflation,

currency depreciation, or economic recession, tend to drive up the cost of debt and could negatively impact financial performance. In these situations, SMEs should focus on strengthening internal financing options and improving liquidity management to avoid excessive borrowing. Additionally, the study suggests that financial institutions and policymakers should work together to ensure that SMEs have access to favorable financing options during difficult economic periods to minimize the impact of high cost of debts.

SMEs should enhance their financial risk management strategies by incorporating economic forecasting and sensitivity analysis into their decision-making process. Understanding how different economic scenarios might affect the cost of debt and financial performance can allow businesses to make more informed decisions about financing. Moreover, SMEs should consider diversifying their financing sources, balancing the use of debt with equity financing or internal funds to create a more resilient capital structure.

#### 5.4 Findings and recommendations from the Documentary checklist

Here in below is a structured table summarising practical insights and recommendations derived from the document review checklist for the study on the cost of debt and financial performance of SMEs in Lira City, Uganda. The table provides a comprehensive overview of the practical implications and recommendations based on the reviewed documents, aiming to enhance the financial performance of SMEs in Lira City.

**Table 14: Findings and recommendations from the Documentary checklist**

<b>Document</b>	<b>Purpose</b>	<b>Key Findings</b>	<b>Recommendations</b>
<b>1. Financial Statements</b>	Assess the financial performance of SMEs.	<ul style="list-style-type: none"> <li>▪ Indicators such as profitability, liquidity, solvency, efficiency, and growth are measurable.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Regularly review financial statements to monitor performance.</li> <li>▪ Implement financial planning strategies to enhance profitability and growth.</li> </ul>
<b>2. Loan Agreements / Contracts</b>	Review the terms and conditions of loans obtained by SMEs.	<ul style="list-style-type: none"> <li>▪ Details on interest rates, repayment schedules, collateral requirements, and credit risk clauses are available.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Negotiate favorable loan terms to reduce financial strain.</li> <li>▪ Diversify funding sources to avoid over-reliance on debt.</li> </ul>
<b>3. Tax Returns</b>	Analyze the impact of tax shield on financial performance.	<ul style="list-style-type: none"> <li>▪ Information on tax deductions related to debt, total tax liability, and tax benefits from debt is present.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Utilize tax planning to maximize deductions.</li> <li>▪ Seek professional advice to ensure compliance and optimize tax benefits.</li> </ul>

<b>4. Credit Risk Assessment Reports</b>	Evaluate credit risk management practices of SMEs.	<ul style="list-style-type: none"> <li>▪ Credit risk scores, default probabilities, and risk mitigation strategies are assessed.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Implement robust credit management practices.</li> <li>▪ Regularly monitor and improve credit profiles.</li> </ul>
<b>5. Bank Statements</b>	Verify transactions related to loans and financial performance.	<ul style="list-style-type: none"> <li>▪ Records of loan disbursements, interest payments, principal repayments, and cash flow management are available.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Maintain accurate and up-to-date financial records.</li> <li>▪ Use bank statements to reconcile accounts and monitor financial health.</li> </ul>
<b>6. Economic Reports</b>	Assess the impact of economic conditions on financial performance.	<ul style="list-style-type: none"> <li>▪ Data on economic indicators such as inflation rate, exchange rate, interest rate trends, and economic forecasts are provided.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stay informed about economic trends to anticipate market changes.</li> <li>▪ Adjust business strategies in response to economic conditions.</li> </ul>
<b>7. Internal Audit Reports</b>	Evaluate internal controls and financial performance.	<ul style="list-style-type: none"> <li>▪ Assessments of operational efficiency, risk management, and compliance with financial policies are conducted.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Conduct regular internal audits to identify and address weaknesses.</li> <li>▪ Implement audit recommendations to enhance performance.</li> </ul>
<b>8. Budget Reports</b>	Analyze financial planning and performance.	<ul style="list-style-type: none"> <li>▪ Comparisons between budgeted and actual performance, financial projections, and variances in financial performance are analyzed.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Develop realistic budgets aligned with business goals.</li> <li>▪ Regularly review and adjust budgets to reflect changing circumstances.</li> </ul>
<b>9. Business Plans</b>	Understand the strategic direction and financial goals of SMEs.	<ul style="list-style-type: none"> <li>▪ Information on growth projections, financial strategies, and the use of debt in business expansion is outlined.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Regularly update business plans to reflect market changes.</li> <li>▪ Align debt strategies with long-term business goals.</li> </ul>
<b>10. Industry Reports</b>	Compare SME performance with industry standards.	<ul style="list-style-type: none"> <li>▪ Industry benchmarks, financial performance of competitors, and industry trends are provided.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Benchmark performance against industry standards.</li> <li>▪ Identify areas for improvement and adopt best practices.</li> </ul>

## **5.5 Areas for Further Research**

Further research could examine how SMEs in different industries adjust their debt management strategies in response to macroeconomic fluctuations such as inflation, interest rate changes, and currency depreciation. A comparative study across multiple economic cycles could provide insights into effective financial resilience strategies for SMEs.

Future studies could investigate how financial institutions, including banks and microfinance institutions, respond to SME financing needs during periods of economic instability. Research could assess the effectiveness of government-backed loan programs, interest rate subsidies, and alternative financing mechanisms in supporting SMEs facing high cost of debts.

Given the recommendation for SMEs to balance debt financing with equity or internal funds, further research could explore the optimal capital structure for SMEs in various sectors. Studies could assess how different financing combinations influence long-term profitability, liquidity, and growth potential.

A deeper exploration into how SMEs integrate economic forecasting and risk management into their financial decision-making could be valuable. Research could focus on the extent to which SMEs use tools such as sensitivity analysis, scenario planning, or predictive analytics to anticipate and mitigate financial risks.

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## APPENDICES

### APPENDIX I: Questionnaire

Dear Respondent,

I am a Postgraduate student of Muni University pursuing a Master's Degree in MBA (Accounting and Finance). As a partial requirement for the award of the said degree, this questionnaire has been designed for the purpose of collecting data on **'cost of Debt and Financial performance of SMEs in Lira city, Uganda.'**

You have been chosen as one of the respondents because of your unique expertise, knowledge, experience and your plight on how cost of debt and financial performance in selected SMEs sector in, Uganda. I hope you will spare your valuable time to provide answers to the following questions by filling in or ticking the right alternatives as may be required.

Please, kindly take note that the research will be conducted and handled with strict confidentiality and you need not indicate your name.

### BIO-DATA SECTION

Variable	Response Options
Name of SME (Optional)	_____
Type of Business	<input type="checkbox"/> Retail <input type="checkbox"/> Manufacturing <input type="checkbox"/> Service <input type="checkbox"/> Other: _____
Number of Employees	<input type="checkbox"/> 1-10 <input type="checkbox"/> 11-50 <input type="checkbox"/> 51-100 <input type="checkbox"/> Over 100
Length of Operation	<input type="checkbox"/> Less than 1 year <input type="checkbox"/> 1-5 years <input type="checkbox"/> 6-10 years <input type="checkbox"/> Over 10 years
Business Ownership	<input type="checkbox"/> Sole Proprietorship <input type="checkbox"/> Partnership <input type="checkbox"/> Company <input type="checkbox"/> Other: _____

**SECTION A: INTEREST RATE AND FINANCIAL PERFORMANCE**

To establish the relationship between interest rates and financial performance.

<b>Statement</b>	<b>1 (Strongly Disagree)</b>	<b>2 (Disagree)</b>	<b>3 (Neutral)</b>	<b>4 (Agree)</b>	<b>5 (Strongly Agree)</b>
1. High-interest rates negatively affect the profitability of my business.					
2. Fluctuations in interest rates make it difficult to plan for cost of debts.					
3. Favorable interest rates improve my ability to manage financial growth.					
4. My business avoids borrowing during periods of high-interest rates.					
5. Changes in interest rates influence my business's ability to meet debt obligations.					
6. Stable interest rates encourage better financial performance in my business.					

**SECTION B: TAX SHIELD AND FINANCIAL PERFORMANCE**

To assess the effect of the tax shield on financial performance.

<b>Statement</b>	<b>1 (Strongly Disagree)</b>	<b>2 (Disagree)</b>	<b>3 (Neutral)</b>	<b>4 (Agree)</b>	<b>5 (Strongly Agree)</b>
1. Tax benefits from debt improve the profitability of my business.					
2. Utilizing tax shields has enhanced the solvency of my business.					
3. Access to tax shields encourages more efficient use of financial resources.					
4. The tax deductibility of interest payments motivates my business to borrow.					
5. Tax benefits reduce the overall cost of debt for my business.					
6. My business benefits significantly from government tax incentives.					

**SECTION C: CREDIT RISK AND FINANCIAL PERFORMANCE**

To determine the contribution of credit risk to financial performance.

<b>Statement</b>	<b>1 (Strongly Disagree)</b>	<b>2 (Disagree)</b>	<b>3 (Neutral)</b>	<b>4 (Agree)</b>	<b>5 (Strongly Agree)</b>
1. High credit risk negatively impacts the liquidity of my business.					
2. Reducing credit risk improves the growth prospects of my enterprise.					
3. Proper credit risk management enhances the efficiency of my operations.					
4. Delayed payments from customers increase credit risk for my business.					
5. Access to credit insurance reduces the financial risks faced by my business.					
6. My business has faced financial challenges due to defaults on loans.					

**SECTION D: ECONOMIC CONDITIONS**

To examine the moderating influence of economic conditions on cost of debt and financial performance.

<b>Statement</b>	<b>1 (Strongly Disagree)</b>	<b>2 (Disagree)</b>	<b>3 (Neutral)</b>	<b>4 (Agree)</b>	<b>5 (Strongly Agree)</b>
1. Interest rate volatility increases financial uncertainty for my business.					
2. Inflation trends significantly impact the financial performance of SMEs.					
3. Limited access to credit hinders the ability to manage debt effectively.					
4. Inflation has increased the operational costs of my business.					
5. My business struggles to adjust to economic changes like inflation or currency depreciation.					
6. The availability of affordable financing options affects my business's growth.					

**Thank you for contributing to the current study. Your answers will add to the collection of knowledge.**

## **APPENDIX II: Interview Guide**

Dear Respondent,

I am a Postgraduate student of Muni University pursuing a Master's Degree in MBA (Accounting and Finance). As a partial requirement for the award of the said degree, this interview guide has been designed for the purpose of collecting data on **'cost of Debt and Financial performance of SMEs in Lira city, Uganda.'**

You have been chosen as one of the respondents because of your unique expertise, knowledge, experience, and insight on the cost of Debt and financial performance in the SMEs sector in Uganda. I hope you will spare your valuable time to provide answers to the following questions by filling in the right alternatives as may be required.

Please, kindly take note that the research will be conducted and handled with strict confidentiality and you need not indicate your name.

### ***Section A: Background Information***

1. Can you please tell me about your business?
  - Type of business (e.g., manufacturing, services, trade, agriculture)
  - Number of years in operation
  - Size of the business (e.g., number of employees, annual revenue)
2. What is your role in the business?
  - Owner, Manager, Financial Officer, etc.

### **SECTION A: INTEREST RATE AND FINANCIAL PERFORMANCE**

Objective: To establish the relationship between interest rates and financial performance.

1. How have recent changes in interest rates affected your business's profit margins?
2. In what ways have high-interest rates impacted your business's profitability and growth?
3. What strategies have you implemented to manage the financial strain caused by higher interest rates?

## **SECTION B: TAX SHIELD AND FINANCIAL PERFORMANCE**

Objective: To assess the effect of tax shields on financial performance.

1. In what ways have rising interest rates, because of tax shields have influenced your company's cash flow and liquidity?
2. Have you considered or undertaken any financial restructuring to maintain liquidity? If so, what approaches have you found effective?
3. How does your business's size or sector impact its ability to navigate liquidity challenges during periods of high interest rates?

## **SECTION C: CREDIT RISK AND FINANCIAL PERFORMANCE**

Objective: To determine the contribution of credit risk to financial performance.

1. How does credit risk affect your business's liquidity and ability to repay loans?
2. What measures do you take to mitigate credit risk in dealing with lenders or customers?
3. Can you share an example of how effective credit risk management has improved your financial performance?

## **SECTION D: ECONOMIC CONDITIONS**

Objective: To examine the moderating influence of economic conditions on cost of debt and financial performance.

1. How has inflation affected your business's revenue and purchasing power?
2. What challenges have you encountered in accessing credit during periods of economic uncertainty?
3. How do fluctuating exchange rates impact your business's long-term planning and growth strategies?

## **CONCLUDING QUESTIONS**

1. How do the terms set by lenders, such as collateral requirements and repayment periods, impact your business's liquidity?

2. Have you explored customized lending solutions to better align with your business's cash flow needs?
3. What role do lender relationships play in negotiating favorable terms for your business?

**Thank you very much for your time and insights.**

### APPENDIX III: Document Review Checklist

Documentary Checklist for the Study on Cost of debt and Financial Performance of Selected SMEs in Lira City, Uganda

Document	Purpose of Document	Information to be Extracted	Available (Yes/No)	Comments
<b>1. Financial Statements</b>	To assess the financial performance of the SMEs.	<ul style="list-style-type: none"> <li>- Profitability (Net Profit, Gross Profit)</li> <li>- Liquidity Ratios (Current Ratio, Quick Ratio)</li> <li>- Solvency Ratios (Debt-to-Equity Ratio)</li> <li>- Efficiency Ratios (Asset Turnover, Inventory Turnover)</li> <li>- Growth Indicators (Revenue Growth, Asset Growth)</li> </ul>		
<b>2. Loan Agreements /Contracts</b>	To review the terms and conditions of loans obtained by SMEs.	<ul style="list-style-type: none"> <li>- Interest Rates</li> <li>- Repayment Schedules</li> <li>- Collateral Requirements</li> <li>- Credit Risk Clauses</li> </ul>		
<b>3. Tax Returns</b>	To analyze the impact of the tax shield on financial performance.	<ul style="list-style-type: none"> <li>- Tax Deductions Related to Debt</li> <li>- Total Tax Liability</li> <li>- Tax Benefits from Debt</li> </ul>		
<b>4. Credit Risk Assessment Reports</b>	To evaluate the credit risk management practices of SMEs.	<ul style="list-style-type: none"> <li>- Credit Risk Scores</li> <li>- Default Probability</li> <li>- Risk Mitigation Strategies</li> </ul>		
<b>5. Bank Statements</b>	To verify transactions related to loans and financial performance.	<ul style="list-style-type: none"> <li>- Loan Disbursements</li> <li>- Interest Payments</li> <li>- Repayment of Principal</li> <li>- Cash Flow Management</li> </ul>		
<b>6. Economic Reports</b>	To assess the impact of economic conditions on financial performance.	<ul style="list-style-type: none"> <li>- Economic Indicators (Inflation Rate, Exchange Rate, Interest Rate Trends)</li> <li>- Economic Forecasts</li> <li>- Impact of Economic Conditions on Business</li> </ul>		
<b>7. Internal Audit Reports</b>	To evaluate internal controls and financial performance.	<ul style="list-style-type: none"> <li>- Efficiency of Operations</li> <li>- Risk Management</li> <li>- Compliance with Financial Policies</li> </ul>		
<b>8. Budget Reports</b>	To analyze financial planning and performance.	<ul style="list-style-type: none"> <li>- Budgeted vs. Actual Performance</li> <li>- Financial Projections</li> <li>- Variances in Financial Performance</li> </ul>		

<b>9. Business Plans</b>	To understand the strategic direction and financial goals of SMEs.	<ul style="list-style-type: none"> <li>- Growth Projections</li> <li>- Financial Strategies</li> <li>- Use of Debt in Business Expansion</li> </ul>		
<b>10. Industry Reports</b>	To compare SME performance with industry standards.	<ul style="list-style-type: none"> <li>- Industry Benchmarks</li> <li>- Financial Performance of Competitors</li> <li>- Industry Trends</li> </ul>		

*This checklist provides a structured approach to gathering relevant documents for the study, ensuring a comprehensive analysis of the relationship between cost of debt and the financial performance of SMEs in Lira City.*

## APPENDIX VI: Table for determining sample size from a given population

The Krejcie and Morgan (1970) table provides sample size recommendations for various population sizes.

**Krejcie and Morgan (1970) Sample Size Table**

N	S	N	S	N	S	N	S	N	S
10	10	100	80	280	162	800	260	2800	338
15	14	110	86	290	165	850	256	300	341
20	19	120	92	300	169	900	269	3500	346
25	24	130	97	320	175	950	274	4000	351
30	28	140	103	340	181	1000	278	4500	354
35	32	150	108	360	186	1100	285	5000	357
40	36	160	113	380	191	1200	291	6000	361
45	40	170	118	400	196	1300	297	7000	364
50	44	180	123	420	201	1400	302	8000	367
55	48	190	127	440	205	1500	306	9000	368
60	52	200	132	460	210	1600	310	10000	370
65	56	210	136	480	214	1700	313	15000	375
70	59	220	140	500	217	1800	317	20000	377
75	63	230	144	550	226	1900	320	30000	379
80	66	240	148	600	234	2000	322	40000	380
85	70	250	152	650	242	2200	327	50000	381
90	73	260	155	700	248	2400	331	75000	382
95	76	270	159	750	254	2600	335	100000	384

## APPENDIX VII: Plagiarism Test Report



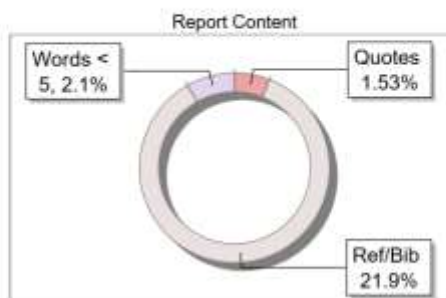
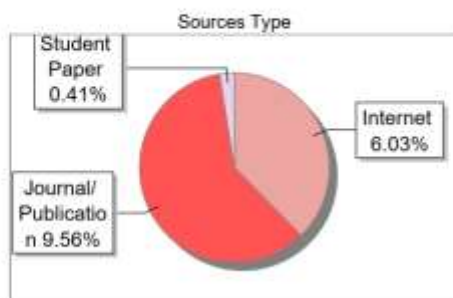
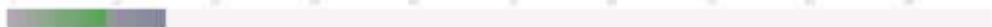
The Report is Generated by DrillBit Plagiarism Detection Software

### Submission Information

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Quotes	Excluded
References/Bibliography	Excluded
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### Database Selection

Language	English
Student Papers	Yes
Journals & publishers	Yes
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Institution Repository	Yes

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