

# Role of Debt Financing on SMEs' Financial Performance in Papua New Guinea

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**Abstract**—The business produces products and provides facilities that contribute towards the GDP which help to extend the level of economic growth and create employment opportunities. Despite businesses carrying out vital parts of the expansion of finance, their activities were dragged down due to the unavailability of acceptable finance for day-to-day activities. The objective of the paper is to observe every connection linking the level of loan finance and financial performance among small medium enterprises in Papua New Guinea. The study focused on those businesses with greater than 3 or less than hundred and fifty employees waged, with extreme borrowing of one and a half million Kinas and a yearly income of more than one hundred thousand Kinas, were formally registered small medium enterprises in Papua New Guinea. The study was based on a survey prior to 279 official entrepreneurs and 130 casual entrepreneurs throughout the countryside and the city zones. Based on the survey, respondents from SMEs with problems having access to finance were ranked second, and difficulty dealing with banks ranked fifth among the top 10 obstacles that they have. Since Papua New Guinea is a developing country, small medium enterprises operations have relied on trade credit. The study concludes that debt financing plays a critical role in small medium enterprises financial performance to ensure growth and profitability in Papua New Guinea. Certainly, there was a helpful connection between trade credit and the firm's sound financial performance.

**Keywords**—GDP, debt financing, informal sector, formal sector SMEs, trade credit

## I. INTRODUCTION

All business sectors that produce merchandise and provide service were considered paramount in the cooperation of industrialized and emerging nations. The SMEs can be defined in different ways in different nations from country to country depending on the variety of conditions, marketing issues, together with borrowing, workers capacity, and revenues. The utmost communal measures used to define SMEs is through the staff level. An average method used in describing micro enterprises is those businesses with less than six staff one and SMEs as businesses with more than six and less than two hundred and fifty staff (Moral *et al.*, 2014). According to Tebbutt (2014), quoted by Sánchez-Medina (2014) defines a SME In Papua New Guinea as a business that legally listed, they must meet four conditions and they are, more than three and less than one hundred and fifty staff waged, with extreme loans around one and-half million kina and yearly gross revenue range within one hundred thousand kinas and fifteen million kinas. Both formal and informal businesses operating in Papua New Guinea donate six percent to total native- made merchandise and are generally focused

on areas such as wholesale, retail, agriculture, fisheries etc.

According to PNG SME Policy 2023 current prime minister office has presented PGK200 million to various financial institutions for SMEs to borrow and have adequate finance for their operation seeing most of them benefiting from loans while compared to previous years results with years ranging from 2021–2023. Even lot of financial assistance provided to SMEs, the major challenge is due to lack of managerial capability to run the business, in terms of marketing, network development, untrained or not willing to get new skills by employees, or resistance to change, supply chain disruptions due to transport connectivity, all caused to slow growth of SMEs in PNG.

This study is required to determine the issues persuading debt financing as a method for fast-tracking the progress and expansion of the success of SMEs in PNG, concerning certain SMEs businesses in PNG. There are numerous important roles played by debt financing on SMEs however, there are certain obstacles encountered by SMEs while seeking financial help from different financial institutions to continue its operation. Therefore, this study focuses on the risk and rewards of debt financing in SME finance. The objective of the study is to identify the role of Debt finance on SMEs financial performance.

## II. LITERATURE REVIEW

### A. Theoretical Frame Work

Human capital theory (Davenport, 1999), human capital is the main source of business, because of individual skills, negotiating, convincing customers, knowledge apply for forecasting demand and profits, maintain values, to get customers credibility, so this theory plays a significant role in developing entrepreneurial skills and firm's credibility as well as external and internal stakeholders confidence (Bozeman and Corley, 2004). If entrepreneurial has good negotiable skills, that leads to attract more debt finance for business expansion.

### B. Review of Literature

25% OF SMEs has problems about the rate of debt finance and agreed that the impact on firms performance is very high (Ayyagari, 2011; Motta, 2020). Debt financing has positive impact on financial performance of SMEs (Harelimana, 2017), The National (2018) funds available to be borrowed to finance business was defined as a capital arrangement for a business taking a transfer of loan comprising of the amount that can be settled more than a year and within a year and agree to reimburse an amount owed within a certain period

with a required interest. The procurements of loans as a principal through ascertain investor to be used in the operations of the firm then recompense with charges imposed on the amount borrowed at an agreed period (Falihat *et al.*, 2018).

Certainly, SMEs operating all over Papua New Guinea are fortunate to have access to finance made available by PNG Government through various financial institutions, provided a breakdown of PGK 200 million into specific amounts, and 50 percent of the fund were deposited into the Bank of South Pacific which was a very good option for those SMEs qualified with terms and conditions set by lenders such interest rate, terms of payment, IPA registration certificate, etc., however, it was unfortunate for SMEs were not qualified and still cater for an employment opportunity and also contribute towards the growth of economic activity in the country. SMEs has more access of debt finance options, but they do not have proper strategy or plan to manage those debt finance for different future plans (Mahmud and Tarik, 2019).

Small and Medium Enterprise sectors (SMEs) perform a critical part in change and growth for every economic activity as Papua New Guinea is in the developing stage. Indeed Vinod (2016) stated that SMEs have been recognized as a key foundation of job opportunities and improvement of economic activity all over the globe, in developing countries in particular.

SMEs subsidies almost half of the native-made merchandise and provide almost entire job opportunities in relatively poor nations, at the same time providing above half of the native-made merchandise, and more than half of the job opportunities were made available in the poor nations. Mustafa and Hidayet (2013) added that debt financing performed a critical part for a financial performance in SME throughout COVID-19 pandemic. According to Ministry of Commerce, Trade and Industry (2016) relative information for PNG is hard to extract the exact information at present, but possible to be assumed through the state's determined business procedure targeting sustenance then simplify a firm's progress from existing to multiple times greater and cater for more people and subsidies half of the native- made product after some years later.

Former prime minister Peter O'Neil mentioned the importance of SMEs in the economy during his speech regarding the investment summit in PNG. He said that the country cannot wait for foreign aid while simultaneously fighting with vast domestic issues and suggested a solution was to allow lenders to finance SMEs so that they can play an important role in providing employment opportunities and support GDP, whichever way SMEs put the country's condition at ease (Sensini, 2020). Without proper debt finance, no firm cannot survive as it requires to adopt market strategies, technology and talented human resources (Harash *et al.*, 2014).

### *C. Role of Debt Financing on SMEs in Papua New Guinea*

Magot (2018) stated that the mixed capital structure with a high portion of debt finance compared to equity finance knowing that there won't be any misunderstanding or misuse of funds between managers and shareholders as they would feel obligated to land lards. However, SMEs in Papua New

Guinea should be careful when acquiring finance from money lenders and restate the danger involved in borrowing while SMEs struggle with financial problems which will eventually result in bankruptcy stated by Beach Accounting Advisory.

The survey has been conducted within the PNG, and almost half of the proprietors replied negatively and specified that they were incapable of borrowing capital from the lenders the reason being the high cost of borrowing, especially the interest rate stated by Sensini (2020). comparative reply by start-up SMEs that many people are eager to establish their businesses but high costs discourage them and also those in progress barely last.

### *D. Deficiency of Conviction to Landers*

According to The National (2018) study, less than a quarter of either owners or managers of SMEs specified that they never believed the banks normally. However, Wendy *et al.*, (2020) proposed that there was no proper reason why SMEs lack trust in banks and refuse to provide firms' financial data to various financial institutions to be qualified to have access to debt finance. Wendy *et al.*, (2020) concluded that a lack of trust led to a lack of finance and an unfavorable relationship between SMEs and banks. Therefore, Wendy *et al.*, (2020) suggested that the probable solution to this issue is a thoughtful and special connection between the landers and businesses to figure out confidence amongst themselves.

### *E. Research Gap*

Many studies has been conducted on the debt finance and SMEs all over the world, but in PNG context very little studies been conducted, but very low level and sample size were also different, so the researcher wish to fill the gap by consideration of large sample in formal and informal sector.

## III. MATERIALS AND METHODS

According to Sekeran (2009) research design is defined as arrangement, summary, or strategy that is used to create a solution to an investigation matter. Survey conducted and cross-examined participants of the informal sector in 3 provinces of PNG to obtain information on labor mobility, and collaboration among local, inter-provincial, and international.

Table 1. Sample size and challenge factors

Sectors	Sample Size	Actual Response	Percentage
Formal	558	279	50
Informal	260	130	50
Total	818	409	50
Factors		Percentage of respondents	
Expensive of loans		49	
Confidence in banks		20	
Complex measures		15	
Too many security conditions		10	
Limited settlement time		6	

Source: Field data (2023)

### *A. Data Collection Method*

An interview guide is several queries that the investigator questions throughout the interview (Vogt, 2007). The questions asked by interviews were intended to acquire information as much as they need for the project.

### *B. Data Collection Instrument*

Primary data was obtained from respondents over

consultations, the owner or the manager from the formal sector, and enterprise participants from the informal sector. Secondary information was obtained from the article applicable. Through favors secondary data including, reports or other issued documents necessary for the study were used.

*C. Data Analysis*

Researchers had used both qualitative and quantitative methods to analyses the data. The data file was arranged in the form of a table, occurrence, and percentage.

**IV. RESULT AND DISCUSSION**

*A. The Response Rate of Respondents*

Previously sample size of formal was able to consult only 558 and 260 from formal and informal managers or proprietors respectively.

*B. Barriers Affecting SMEs from Accessing Debt Financing in PNG*

A Primary and Secondary data source was used in this study. Hence, secondary data was used to fully determine various barriers that hold SMEs back from accessing the finance made available by different financial institutions in Papua New Guinea.

Table 2. Factor influencing access to debt financing and respondents (percentage) in PNG Source: Data (2023).

<b>Factors</b>	<b>Percentage of respondents</b>
Expensive of loans	49
Confidence in banks	20
Complex measures	15
Too many security conditions	10
Limited settlement time	6

Referring back to the above table, almost half of the respondents answered negatively on the cost of borrowing issues, 20% of the respondents were having an issue regarding lack of trust towards the bank, 15% of the respondents responded negatively on complicated application procedures, 10% of having an issue with collateral requirement and 6% of the respondents answered negatively on short loan repayment period. Hence, they suggested that the major influencing factor of business in the country was the expensive charge of loans among other factors.

**V. CONCLUSION**

As per the Research almost half of the respondents specified that the high cost of borrowing loans from commercial banks and official financiers was the reason why they were unable to access the debt financing. The previous table reflects the cost of borrowing funds was the main blockage that dragged SMEs from accessing financial institutions. Many of the population who may be keen to establish their own business are unable to access debt finance because of the high-interest rate imposed by lenders.

According to study more than a quarter of business respondents were having trust issues with banks. Hence, SMEs from time to time refuse to provide financial data to

the bank for the purpose of confirming the repayment capacity of the firm. Consequently, they were being prohibited by banks from accessing bank loans.

Regarding application procedures specifying that they were holding back from accessing the debt finance of the reason being complicated process involved in securing the loan. Numerous owners of the SMEs did not complete the top stage of learning and extensive and complex procedures turned out to be hard for them to understand and they were not able to get the loan and also proposed that SMEs owner who was unable to comprehend the procedures for accessing loans were bound with extra costs upon seeking assistance from professional services.

Attaining loans from lenders is paramount and intended for progress and financial stability for SMEs in Papua New Guinea. Despite the important roles played by debt financing, SMEs are persistently finding it hard to access the borrowing made available by commercial banks and financial institutions. Another researcher argues that there is a possibility of bankruptcy from using debt finance as a source of capital for start-ups. Moreover, there are numerous obstacles encountered by SMEs in PNG when getting into debt finance in terms of expensive charges on the amount acquired (interest rate), absence of confidence in financial institutions, complex steps, security conditions, and limited credit settlement dates.

Both formal and informal sectors of SMEs in PNG turn out to be major factors in the growth and profitability of the economy as the country is in the developing stage. This study generates some recommendations on the challenge come across by SMEs when accessing debt finance.

Apart from all other factors influencing access to debt finance, the cost of borrowing is the leading factor. Due to the high interest impose the borrowing which accumulates to a huge amount that cannot be bear by SMEs with low financial performance. Therefore, PNG Government should take into consideration the above issue and consult those financial institutions imposing high-interest rates to reduce down to a reasonable level. SMEs must be encouraged to be more innovative and maximize the affective use of available resources.

The second major obstacle to manipulating access to debt finance was a lack of trust in banks. Due to a lack of trust and refusal to provide financial information SMEs were unable to access debt finance. There was no point in not trusting the bank, SMEs should provide financial data. Not only for securing loans but for themselves to measure their financial position, and performance and predict the profitability of their SMEs. In addition, those SMEs accessing borrowing from the bank should establish a good credit history with the bank to continue accessing debt finance.

**CONFLICT OF INTEREST**

The authors declare no conflict of interest.

**AUTHOR CONTRIBUTIONS**

Viswanadham Nadiminti designed the idea and prepared the paper; Matthew Kuusa collected data; E. Moses type the work; all authors had approved the final version.

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