Effect of Financial Literacy and Performance SMEs. Evidence from Kenya

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Abstract
The main purpose was to determine the relationship between financial literacy and performance of small and medium enterprises in Uasin Gishu County. The study was informed by the theory of planned behavior. The study comprised of 1053 registered SMEs owners in Uasin Gishu County. Cluster and random sampling techniques were used to select a sample size of 290 SMEs. Data was collected using structured questionnaires. Test-retest technique was employed to test the reliability of the data collection instruments. Descriptive statistics was used to analyze the data, and data was presented in the form of frequencies, tables, percentages, means and standard deviation. Inferential statistics and Pearson correlation were used to analyze data. The findings are indicative of a significant effect of borrowing financial literacy and budgeting financial literacy on SME performance. It is recommended that SME owners enhance the training on the calculation of interest rate and need to have budget expertise since they dictate whether the budget would be implemented as prepared or not. Finally, there is a need for employees to have the necessary reporting and analyzing skills.
Keywords: *Financial Literacy, Borrowing Financial Literacy, Budgeting Financial Literacy SME Performance*

1.1 Introduction

The performance and growth of Small and Medium Sized Enterprises (SMEs) have throughout the nations, been of great concern to, among others, development economists, entrepreneurs, governments, venture capital firms, financial institutions and non-governmental organizations (Eniola & Entebang, 2014). The success or failure of small and medium enterprises (SMEs) is contingent on their financial viability, and one of the most common problems facing such firms is their ability to secure sufficient cash flow and working capital to remain profitable. It was noted as one of the top problems facing SMEs as long ago as the Bolton Report in the early 1970s (Bolton, 1971). This has been a recurring theme in the small business literature since that time (Kennedy, Tennent, and Gibson, 2006). This was highlighted in the 2014 Sensis Business Index report where the most important prime concerns of Australian SME owner-managers were a lack of sales and cash flow, bad debts and profitability (Sensis, 2014).

Financial literacy has been shown to be essential in improving transparency, efficiency, accuracy and accountability resulting in the organizations achieving their objectives (Koitaba, 2013). Increasing the chances of success among SME's would have huge implications for the growth and socio-economic wellbeing of a country (Asian-Pacific Economic Cooperation, 2004). Thus, understanding predictors of success in SME's is critical. The creation of more successful SME's could potentially create new jobs, increase trade, consequently, the GDP of the country. Although it has been difficult to ascertain why in similar situations some entrepreneurs fail while others succeed, this study focuses on "entrepreneurial competencies" to offer a practical means of addressing the phenomenon. Capacity building of SMEs in terms of preparing financial statements and business plans, as well as improving their financial literacy and management training, is shown to have a positive impact on SME development. Furthermore, strengthening the horizontal linkages with other SMEs and vertical linkages with larger firms would improve SMEs' market access (Hogarth et al. 2002). Effective implementations of financial literacy skills lead to improvement in business performance due to improved ability to track business events from the record system (Siekei, et al. 2013). Most new business owners are daunted by the mere idea of bookkeeping and accounting.

It is generally accepted that SMEs are becoming increasingly important in terms of employment, wealth creation, and the development of innovation. However many SME's encounter problems during their lifetime and as a result, many firms perform dismally and fail to grow. In addition, it is generally known and accepted that there is a high mortality rate of SMEs within the first two years. Given this high failure rate, it becomes vital to research the factors required to enable the SMEs to survive and indeed progress to the growth phase of the organizational life cycle (Kamunge *et al.*, 2014). This calls for financial literacy intervention to train the SMEs on how to use the available means of accessing financial services to improve their enterprises and also reduce the cost of doing business. Financial training is one of the factors that impact positively on the growth of SMEs because entrepreneurs adequate financial literacy are better placed to adapt their enterprises to constantly changing business environments (King & McGrath, 2002).

Internally, most SMEs lack training and management skills to enable to manage funds effectively. Externally, SMEs lack the necessary collateral and have the capacity to absorb the only small amount of funds from financial institutions. This prevents the enterprises from accessing adequate credit because of high intermediation costs, including the cost of monitoring and enforcement of loan contracts. Several initiatives have been advanced by the state and non-state sectors to broaden access to affordable credit, and financial management to enable SMEs to manage finances efficiently. However, it is not clear whether financial literacy initiatives have translated to better financial management, enterprise performance, improved access to loan capital, and loan repayment of SME borrowers (CMA, 2010; Wanjohi, 2011). G20 Seoul Summit (2010) states that information asymmetry arising from SMEs' lack of accounting records, inadequate financial statements or business plans also makes it difficult for creditors to assess the creditworthiness of potential SME proposals. As the lack of financial literacy, operational skills, including accounting and finance and business planning represents a formidable challenge for SME borrowers.

However, reviews of the literature on the effect of financial literacy on SME performance are yet to be conducted. Most of the studies are on firm characteristics and performance. For example, a posited relationship between firm size and performance was found by Vijayakumar and Tamizhselvan (2010). Most of these studies have only been done in large firms. Therefore this study intends to fill the gap by identifying the relationship between financial literacy and performance of small and medium enterprise in Uasin Gishu County. Thus, the study hypothesized that;

H_{O1}: *There is no significant effect of borrowing financial literacy on performance of small and medium enterprise*

H_{O2}: *There is no significant effect of budgeting financial literacy on performance of small and medium enterprise*

2.1 Theoretical Framework

Financial literacy theory argues that the behavior of people with a high level of financial literacy might depend on the prevalence of the two thinking styles according to dual-process theories: intuition and cognition. Dual-process theories (Evans 2008) embrace the idea that decisions can be driven by both intuitive and cognitive processes. Dual-process theories have been studied and applied to many different fields, e.g., reasoning and social cognition (Evans 2008).Financial literacy remains an interesting issue in both developed and developing economies and has elicited much interest in the recent past with the rapid change in the finance landscape.

According to this theory, Gallery, Newton and Palm (2011) framework financial knowledge is a form of investment in human capital, and many empirical surveys establish that people need to know much more to become informed. The authors show how financial literacy shapes economic outcomes. They conclude with thoughts on research needs to better inform theoretical and empirical models as well as public policy. Financial literacy theory argues that the behavior of people with a high level 14 of financial literacy might depend on the prevalence of the two thinking styles according to dual-process theories: intuition and cognition. Dual-process theories (Idowu 2010) embrace the idea that decisions can be driven by both intuitive and cognitive processes.

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Financial literacy remains an interesting issue in both developed and developing economies and has elicited much interest in the recent past with the rapid change in the finance landscape. Atkinson and Messy (2005) define financial literacy as the combination of investors understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for assistance, and to take other effective actions to improve their financial well-being. Financial literacy helps in empowering and educating investors so that they are knowledgeable about finance in a way that is relevant to their business and enables them to use this knowledge to evaluate products and make informed decisions. It is widely expected that greater financial knowledge would help overcome recent difficulties in advanced credit markets (Lusardi and Oliver, 2006).

2.2 Empirical Review

Borrowing Financial literacy and Performance of Small and Medium Enterprise

A study by Ekanem (2010) of SME owner-managers in the printing and clothing manufacturing sectors in Ethiopia found that managerial, financial literacys differed by sector. For example, the average collection period for accounts receivable within the clothing industry was 30 to 90 days, while that in the printing industry was 14 days. Where clothing manufacturers employed “closed loop” learning with a resort to standard industry conventions, the printers were more likely to apply “open loop” learning, relying on advice from accountants and their own experience when setting their financial literacys in debtor collection and credit management. Many owner-managers do monitor their cash flow and financial positions closely with a keen eye on debtors and creditors (Kubickova and Soucek, 2013).

In fact, there is often a high focus by owner- managers on financial performance measures at the expense of non-financial ones, although such financial management is frequently ad-hoc and less systematic or formal than it should be (Perera and Baker, 2007). However, in many developing economies the use of formal accounting systems, credit management, and cash flow monitoring is largely ad hoc and informal in nature (Orobia et al., 2013; Mungal and Garbharran, 2014)

In a study conducted by Prakash & Poudel (2002) in the United States, a survey of 50 financial institutions was conducted, primary and secondary data was used, and data analysis was done using a regression model. The results of this study found credit risk management financial literacys is the best financial literacy in financial institutions and above 90% of the private financial institutions in the country have adopted the best financial literacys. Inadequate credit policies are still the main source of the serious problem in the financial industry as a result; effective credit risk management had gained an increased focus in recent years. The study concluded on the need to manage credit risk in the entire portfolio as well as the risk in individual credits transactions.

A study was conducted in Uganda by Omara (2007) to investigate the credit Assessment process and repayment of bank loans in Kampala, a case study of Barclays was done. A sample of 73 respondents was interviewed, and the results of the study showed that there was delay by Barclays bank in scoring loans, the bank charged commitment fee to both new and existing customers. Data was analyses using frequencies and tables it was found out that Barclays bank required collateral for loans above UGX 20 Million. There is also a review of empirical studies, for instance, Djankov, McLiesh, & Shleifer, (2007), carried out a on the effects of credit management on loan repayment in private credit in 129 countries in Easter Europe, financial managers of the finance institutions were interviewed and data analysis was carried out using mean and standard deviation. The findings of the study concluded that credit management financial literacys were significant in facilitating loan repayment.

In his study, Simiyu (2008) investigated on the techniques used by micro finance institutions in the management of credit risk in Kenya, and to examine the main challenges facing the micro finance institutions operating in Kenya in the management of credit risk. To satisfy the research objectives, the study used a descriptive research design comprising a sample of thirty (30) micro finance institutions. The sampling frame included the Central bank of Kenya Directory of micro finance institutions. Purposive sampling was used to select one credit officer and one loan officer from each of the sampled institutions. Primary data was collected using semi-structured questionnaires. The questionnaires were dropped and picked up later, and others sent and received via email. The target respondents were the institutions' loans and credit officers. Once the pertinent data had been collected the researcher carried out analysis of the same using mean scores, percentages, and standard deviations.

Budgeting Financial literacy and Performance of Small and Medium Enterprise

Joshi et al. (2003) examined budgeting financial literacys by a survey of 54 medium and large sized companies in Bahrain focusing on budgeting planning and control, budget participation and rewards, and performance evaluation. These researchers found that an increase in the firm size lead firm to implementing a more comprehensive budgeting process to achieve better performance. Further, the firm size and its complexity of operations generally influenced the nature of the budgeting adopted.

A study conducted by Chidi & Shadare (2011) in Nigeria focusing on challenges confronting human capital development in SMEs in Nigeria found that budgeting among SMEs faced challenges by the businesses not taking ownership or not being accountable, there being a lack of cooperation and/or participation and a lack of understanding of the budgeting process or what’s required. This was compounded by the inability to meet, deadlines, padding their budgets/providing unrealistic numbers and sheer ignorance of the importance of budgeting by the business owners. These researchers confirmed that the skill that managers have concerning budgeting affect the budgeting process. The influences of the managers inform whether the budget would be implemented as prepared or not.

Based on Mahmood (2008), study, if the owners of SMEs have clearly defined the relationship with the business, the budgeting process becomes more formal, sophisticated and accurate due to the limited influence of the owners. Diamond & Khemani (2006) studied accounting systems among businesses in the developing countries, focusing on Africa deduced that budget execution and accounting processes were either manual or supported by very old and inadequately maintained software applications and hardware. He found that this had damaging effects on their functioning due to the consequent lack of reliable and timely revenue and expenditure data for budget planning, monitoring, expenditure control, and reporting negatively impacting budget management. Further, the study found that there was poorly controlled commitment of resources. This meant that the nature of the computerization of accounting affected the budgeting process to a large extend.

Joshi et al. (2003) suggested that large companies tend to carry a detailed budget process and achieve better performance. Therefore, the size and complexity of the company and its operations generally affect the nature of the budget process that should be adopted and ultimately affect the performance of the company. Moreover, the size of the company is also one of the variables that are generally used in quantitative research. According to Wijewardena and Zoysa (2001) budget planning and budget, control differs between small and medium enterprises.

As proposed by Wijewardena and DeZoysa (2001) the formal budget planning and the formal budget control have two important facets of the regular budget process by SMEs. They classified three special types of firms. In the first category, firms do not use any type of budget. In the second group, they represent a less comprehensive planning process with respect to a few areas of operation i.e. simple budgeting. In the third group, many different areas of operation are included with regard to the detailed budget plan used by the firms. These firms engage in a more comprehensive planning process. In addition, the administrative control of the budget is focused on the third category in terms of budget control

Most of the reviews on recordkeeping financial literacy and firm performance (Peacock, 2008; Williams, 2010), borrowing financial literacy and firm performance (Orobia et al., 2013; Mungal and Garbharran, 2014), financial reporting and analysis financial literacy and performance of small and medium enterprise (Omara, 2007;Moores & Mula, 2003; Maingot and Zeghal, 2006) and budgeting financial literacy and performance of small and medium enterprise (Chidi & Shadare, 2011; Mahmood, 2008; Wijewardena and DeZoysa, 2001) have argued a link between the above financial literacy and performance of small and medium enterprise. However, those reviews have not clearly articulated the relationship between financial literacy and performance of the small and medium enterprise. The study ate also based developed countries and in larger firms.

3.0 Materials and Methods

The study adopted explanatory research design. From the target population of 1053 SMEs, Taro Yamane (1973) sample size formula will be used to select a sample size of 290. The study used Cluster and simple sampling technique to select the SMEs where owners/managers were picked. The primary data, on the other hand, was obtained from questionnaires. Cronbach alpha was used to test the reliability of the research instruments . The collected data was analysed through the use of both descriptive and inferential statistics. Descriptive statistics were presented in the form of frequencies, percentages, means and standard deviation. The researcher used inferential statistics, Pearson correlation, and ANOVA to show the relationship between the variables.

4.0 Findings and Discussions

This section presents analysis and findings from the data collected through the use of questionnaires. The researcher also found it necessary to establish the borrowing financial literacy. The findings are presented in table 1.most SMEs are not trained on calculating the interest rates of funds advanced to the business by lenders. This is vital because the rates should be sustainable in order to realize profits at the end. Before borrowing, they do not check on the profit and how they are able to repay the loan (mean of 2.53 and standard deviation of 0.852). Firm do not hire expertise to advice on the borrowing behavior,

Table 1 Borrowing Financial literacy

	Mean	Std. Deviation
I have been trained on calculating the interest rate	2.44	0.876
Before borrowing, we check on how profit and of we are able to repay the loan	2.53	0.852
My firm hire expertise to advice on our borrowing behavior	2.32	0.795
We calculate risk before asking for loan from a financial institution	3.42	0.953
We weight our options on which financial institutions we should ask loan from	3.17	1.451
Composite	2.7759	0.60458
Cronbach Alpha	0.711	

This section sought to establish the budgeting financial literacy. The results are as presented in table 2. Findings showed that most employees have no budget expertise and if they indeed adhere to strict budgets for their businesses. The results on the budgeting financial literacy summed up to a mean of 2.6652 and standard deviation of 0.78491.

Table 2 Budgeting Financial literacy

	Mean	Std. Deviation
The organization has employees with budget expertise	2.85	1.296
The organization regularly prepare it budget activities	2.49	0.947
The organization has hire budget expertise	2.81	0.879
The firm involve and allow its employee to participate in budget process	2.51	0.966
Budgeting Financial literacy	2.6652	0.78491
Cronbach Alpha	0.833	

Table 3 presents the results on firm performance. The findings showed that have averagely performed well in terms of Growth in profit level in relation to their Competitors and Growth in sales in relation to their competitors. This summed up to a mean of 3.82 and standard deviation of 1.017.

Table 3 Firm Performance

	Mean	Std. Deviation
Growth in sales in relation to your expectations	2.66	0.999
Growth in sales in relation to your competitors	3.32	0.914
Growth in profits in relation to your expectations	3.04	1.241
Growth in profit level in relation to your Competitors	3.44	1.123
Increase in number of employees	2.75	1.066
Increased market size in new markets in relation to your	2.78	1.129
Increased market size in new markets in relation to your tutors	2.89	1.328
composite	3.136	0.501
Cronbach Alpha	0.911	

4.1 Hypothesis testing

The study exhibited a strong relationship between budgeting financial literacy and SME performance (r = 0 .590, p-value < .01). However there was a weak relationship between borrowing financial literacy and SME performance(r = 0.140, p-value < .05). the model summary of multiple regression models, the results showed that all the four predictors (budgeting financial literacy and borrowing financial literacy) explained 41.8 percent variation of SME performance (R squared =0.319).Also, the Durbin-Watson value (1.311) is the thumb rule hence no autocorrelation.

Table 4 Regression Results

	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics		correlations
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF	zero-order
(Constant)	1.939	0.141		13.72	0.000			
Borrowing Financial literacy	-0.143	0.061	-0.172	-2.33	0.021	0.486	2.058	0.140**
Budgeting Financial literacy	0.27	0.041	0.424	6.662	0.000	0.657	1.522	0.590**
R Square	0.418							
Adjusted R Square	0.407							
Std. Error of the Estimate	0.38551							
Durbin-Watson	1.311							

a Dependent Variable: SME performance

Hypothesis 1 (H_{o1}) stated that borrowing financial literacy has no significant effect on SME performance. Findings showed that borrowing financial literacy had coefficients of the estimate which was significant basing on β_2 = -0.172 (p-value = 0.021 which is less than α = 0.05) hence we reject the null hypothesis and conclude that borrowing financial literacy has a significant effect on SME performance. With reference to the borrowing financial literacy, SME owners have been trained on calculating the interest rate. Furthermore, before borrowing, SME owners check on the profit level and how they will be able to repay the loan. The SMEs have also gone to the extent of hiring experts to advice on the borrowing behavior. Besides, SME owners weigh their options on which financial institutions they should ask a loan from. However, the calculation of risks before asking for a loan was not a common financial literacy among the SMEs. Consistently, a study conducted by Prakash & Poudel (2002) in the United States revealed that loan management is the best financial literacy in financial institutions since it instrumental in enhancing firm performance. Besides, Djankov et al., (2007) concluded that credit management financial literacys were significant in facilitating loan repayment.

Hypothesis 2 (H_{o2}) stated that budgeting financial literacy has no significant effect on SME performance. Findings showed that budgeting financial literacy had coefficients of the estimate which was significant basing on β_4 = 0.424 (p-value = 0.000 which is less than α = 0.05) thus we fail to accept the hypothesis and conclude that budgeting financial literacy has a significant effect on SME performance. This suggests that there is up to 0.424 unit increase SME performance for each unit increase in budget financial literacy. In line with the results, Joshi et al. (2003) examination of budgeting financial literacys by a survey of 54 medium and large sized companies in Bahrain found that an increase in the firm size lead firm to implementing a more comprehensive budgeting process to achieve better performance. In a similar vein, a study conducted by Chidi & Shadare (2011) in Nigeria focusing on challenges confronting human capital development in SMEs found that lack of understanding of the budgeting process was detrimental to the performance of the SMEs. From the extant literature, it is evident that budgeting enhances SME performance. The results, therefore, augment prior findings. Finally, the results on budgeting financial literacy revealed that the organization has employees with budget expertise. As a result, the organization regularly prepares its budget activities and in other instances hires budget expertise. Moreover, the SME owners confirmed that the employees participate in the budget process.

The rule of thumb was applied to the interpretation of the variance inflation factor. From table 4, the VIF for all the estimated parameters was found to be less than 4 which indicate the absence of multi-Collinearity among the independent factors. This implies that the variation contributed by each of the independent factors was significant independently and all the factors should be included in the prediction model.

5.0 Conclusion and Recommendations

Borrowing financial literacy has a significant effect on SME performance. SME owners possessed the requisite knowledge on effective and efficient borrowing financial literacys. Precisely, most of them had undergone training on the calculation of interest rate. They are therefore capable of ascertaining whether or not a project will yield and the amount that is to be invested. Moreover, experts' advice on the borrowing behavior giving the SMEs a better chance of efficiently utilizing the borrowed funds and realizing profits.

Budgeting financial literacy has a positive and significant effect on SME performance. The preparation of budgets coupled with budget expertise provides a spending plan for finances making it possible for the availability of funds to enhance future growth and overall performance of SMEs. This, however, requires the participation of employees in the budget process in order to realize improved performance.

It is therefore recommended for SME owners to enhance the training on the calculation of interest rate. Besides, its utmost important for SMEs to assess the manner in which they will pay the borrowed funds and the profit that can be yielded. Experts need to be sought to advice on the borrowing behavior, and the risks need to be calculated before asking for a loan.

Financial information is useful mainly in evaluating the success of past decisions and in determining present position. There is thus need for periodical reporting on the balances of their accounts. The growth of accounts also needs to be analyzed and evaluated periodically. Additionally, there is a need for employees to have the necessary reporting and analyzing skills. Budgeting financial literacy has a positive and significant effect on SME performance. It is, therefore, necessary for employees to have budget expertise. Most importantly, SME owners need to have budget expertise since they dictate whether the budget would be implemented as prepared or not. Moreover, budgets should be prepared regularly with full participation of employees in the budget process.More research is needed in this subject area to fully establish the effect of record keeping on SME performance since the study exhibited no significant effect. Major contextual and settings to be considered in future researches should consider insights from this study influencing SME performance including the three factors: 1) *budget financial literacy; 2) financial reporting and borrowing financial literacy* as playing an important role in enhancing SME performance.

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