

Effect of Financial Literacy on Financial Performance of Medium Scale Enterprise; Case Study in Hawassa City, Ethiopia

Leyla Jemal*

Wolaitasodo University, College of Business and Economics, Department of Accounting and Finance, Ethiopia

*Corresponding Author: Leyla Jemal, Wolaitasodo University, College of Business and Economics, Department of Accounting and Finance, Ethiopia, Email: nesimahade@gmail.com

ABSTRACT

Now a day's many medium enterprises are facing difficulty in running their business properly and unable to go for long period of time. Financial literacy allows business owners to make informed and effective decisions with all monetary matters in order to create healthy business. However, the effect of financial literacy on business financial performance was not adequately studied. Therefore, this paper is carried out with the objective of assessing the effect of financial literacy on financial performance of medium scale enterprises in Hawassa city. Explanatory research design and descriptive survey design with mixed approach was employed to carry out this study. From the total 2139 registered medium enterprises in Hawassa City, by taking 276 selected medium enterprises through stratified random sampling technique the researcher investigated the effect of financial literacy variables such as Budgeting literacy, Debt management literacy, Accounting literacy and saving literacy on financial performance of medium enterprises. The financial performance measurement used in this study was Return on asset. The researcher used both primary data which were collected using a questionnaire and secondary data obtained from the financial statement of medium enterprises in order to achieve the underline objective. The statistical methods of data analysis were both descriptive and inferential statistics. In addition Stata version12 software was used to analyze the collected data. The result of the study has shown that budgeting literacy, debt management literacy, accounting literacy and saving literacy has positive and significant effect on financial performance of medium scale enterprises in Hawassa city. The study recommends the government to invest in enhancing the financial literacy level of medium scale enterprise owners through trainings and incorporating financial literacy issues in formal education; so as to improve the financial performance of the MEs.

Keywords: Financial literacy, financial performance, Medium enterprise and Return on asset.

INTRODUCTION

Ethiopia is a developing country which has a vision to join middle income economies by the year 2025. Medium enterprises (MEs) have expected to play great role to realize this vision. Even though, the country's economy is greatly reliant on farming; now days, the development of this sector is become a vital issue for Ethiopia. Because the contribution of those enterprises to economic development is high. As stated by FDRE, (2011) medium enterprises play vital role for socio-economic growth and serves as vehicles for employment opportunities and ways of enhancing wealth creation by support the economic growth.

Medium scale enterprises are important sector for majority people who have low capital and

skill to work together in a form of association. The sector also used as a connection of diverse levels of segments in which the access of job opportunity was facilitated. Many operators have joined this sector to get job opportunity and income and to develop their capacity in their area of living (Shiferaw, 2013). Even though, medium enterprises are important ingredients for stable and equitable growth in any economy mostly in developing countries: several businesses are encountering with many problems and their contribution is not such much as that of rich countries (Kamunge, Njeru & Tirimba, 2014). According to Bosma and Harding (2006), the reason for many firms to fail is because of having in adequate financial literacy, lacking sufficient business perception. Financial literacy defines as the capability to use

knowledge and abilities to manage financial assets successfully for existence of healthy business (Abdeldayem, 2016). It helps individuals in using its resource effectively. Making the right financial choices is very important decision in the life of business with long-term financial consequences. Management of financial matters of a firm is difficult task and enterprises need to make a choice out of a large menu of financial needs of which many have complex features (Patrick, 2015).

Therefore, there should be more attention on increasing the level of financial literacy as this would help in achieving many objectives of organizations (Mandell, 2008). Because, the financial illiterate owners may not know what danger they have gotten themselves into. Financial literacy is critical for promoting access to finance by creating incentives and environments that promote desired financial behaviors such as saving, budgeting, or using credit wisely (Miller, Godfrey, Levesque and Stark, 2009).

Thus, a significant obstacle to performance growth of sustainable medium enterprises throughout the developing world is a lack of knowledge, skills, attitude and awareness to manage and direct the finances of their organization in a strong, clear, and professional way (Adomako & Danso, 2014). Like other developing countries of the world, Ethiopian enterprise owners are facing with financial literacy problems in running their businesses (Abebe, Tekle & Mano, 2016).

STATEMENT OF THE PROBLEM

Business financial outcomes are the result of the financial decision that is already made and decisions also depend on their knowledge about the subject matter.

Financial literacy becomes crucial in decisions of firms related to finance and their subsequent performance (Adomako & Danso, 2014). Van Rooij and Lusardi (2007) find that financial decision-making is affected by financial literacy. The extensive lack of financial literacy casts serious doubts on the ability of individuals to make responsible decisions (Massimo & Ornella, 2012). Accordingly, a wrong decision can have long lasting effect not only on the profit but on very survival of the enterprise (Patrick, 2015).

As literatures show as, many medium enterprises are facing difficult monetary management

problems and unable to go for long period of time. Kotze and Smit, (2008) stated that if the owners-managers are illiterate concerning their organizational finances, the financial knowledge of their firms will also be lacking and this will lead to reduction in innovation that can transform into competitive capability, unable to access different sources of financing provision due to non-awareness and this attitude will lead to possible failures of enterprises.

Even though, some studies have been conducted related to financial literacy, not much research has covered the effect of financial literacy on financial performance of medium scale enterprise. Therefore, the purpose of this study was to examine the effect of financial literacy on financial performance of medium scale enterprises operating in Hawassa city.

RESEARCH METHODOLOGY

Research Design and Approach

The study employed both explanatory research design and descriptive survey design, which can assist the study clearly explaining and describing the state of affairs in the study area. According to Kothari (2004) there are three research approaches these are; quantitative approaches, qualitative approaches, and mixed of both approaches. The researcher used mixed approach; i.e. quantitative and qualitative research approaches.

POPULATION OF THE STUDY AND SAMPLING DESIGN

Population of the Study

The total population of the study is medium enterprises that are operating in Hawassa city, which can provide financial report (income statement and balance sheet). Data available from M& SDE indicate that there are 2, 139 medium enterprises in Hawassa city. From this, researcher focused on those enterprises which have been served in Tabor, Haik dar and Menahria sub-city operation and there are 893 medium enterprises in Tabor (316), Haik dar (284) and Menahria (293) sub-cities. The three sub-cities were selected because maximum numbers of enterprises are found there and flow of operation is high which is suit for researcher.

Sampling Design

A sample design is a definite plan for obtaining a sample from a given population. For this study stratified random sampling employed in order to

Effect of Financial Literacy on Financial Performance of Medium Scale Enterprise; Case Study in Hawassa City, Ethiopia

get the appropriate sample. According to Kothari (2004) if a population from which a sample is to be drawn does not constitute a homogeneous group, stratified sampling technique is generally applied in order to obtain a representative sample. Then the populations were divided into several sub-populations called strata and then select items randomly from each stratum to constitute a sample.

The researcher used Yamane and Taro (1967) formula to arrive at the sample size from those diverse sectors which is given as:

$$n = \frac{N}{1+N(e)^2} = \frac{893}{1+893(0.05)^2} = \frac{893}{1+893(0.0025)} = \frac{893}{1+2.2325} = \frac{893}{3.2325} = 276.25 \approx 276$$

n=276 medium enterprises are sample scale of the study

Where;

n is sample scale,

N is population study

e is margin of error (0.05)

DATA SOURCE AND COLLECTION METHOD

In this study both primary and secondary data were collected from relevant sources and used for the achievement of the study objective.

The Primary data were collected from individuals who are owners of medium scale enterprises by using questionnaire. The questionnaire was a 5 point Likert scale with answers varied between one and five: strongly disagree(1); disagree (2); normal (3); agree (4) and strongly agree (5) where the lowest scale represent strongly disagree and the highest scale represent strongly agree.

The questions were used to determine how financially knowledgeable the respondents are. The questionnaire for medium enterprises owners was translated in to Amharic for ease of understanding. Secondary data were collected from financial statements of respondents. An audited financial statement of enterprise which comprises of balance sheet and income statement for a period of 2017 was used to achieve the required objectives.

METHODS OF DATA ANALYSIS

In this study descriptive and inferential statistical analysis were employed. Descriptive analysis involved use of means and standard deviations. While inferential analysis involved

use of correlation and multiple linear regression analysis.

RESEARCH FINDINGS

Correlation Coefficients

Correlation analysis tells the direction as well the strength of relationship exists between independent and regressed variables. It is important to find the association between two variables. The nearest coefficient gets from -1 or +1.0, the strong the relationship (Kubiszyn & Borich, 2013).

In this research Karl Pearson's coefficient of correlation was used to see the degree of association between dependent variable financial performance measured by Return on asset (ROA) and independent variables financial literacy in terms of BL, DML, and SL. Correlation.

Table1. Correlation between Variables

| | ROA | BL | DML | AL | SL |
|-----|--------|--------|--------|--------|----|
| ROA | 1 | | | | |
| BL | 0.6353 | 1 | | | |
| DML | 0.5755 | 0.5654 | 1 | | |
| AL | 0.5704 | 0.5193 | 0.5654 | 1 | |
| SL | 0.6159 | 0.5341 | 0.4966 | 0.4381 | 1 |

Source: Research Data, 2018

As it has seen in the table above, there is highest positive correlation between return on asset and four variables of financial literacy (debt management, accounting, budgeting and saving literacy). That means financial performance increases as financial literacy increases.

Normality Test

In order to determine the appropriate statistical test, it is required to test the normality of the data. In this study the researcher used Shapiro-Wilk test to test normality of data. The null hypothesis for this test is that if p-value is less than 0.05 the distribution of the residual is not normal.

Table2. Shapiro-Wilk W test for normal data

| Variable | Obs | W | V | z | Prob > z |
|----------|-----|---------|-------|-------|----------|
| Residual | 276 | 0.99201 | 1.582 | 1.072 | 0.14176 |

Source: Research Data, 2018

In this case, the p- value for the model is greater than 0.05. So, reject the null hypothesis and the residual has normal distribution pattern.

Multi Collinearity Test

Multi collinearity refers to a situation in which

Effect of Financial Literacy on Financial Performance of Medium Scale Enterprise; Case Study in Hawassa City, Ethiopia

two or more explanatory variables in a multiple regression model are highly linearly related. If the variance inflation factor is less than <10 multi collinearity would not be a problem.

Table3. Degree of Multi collinearity for variables

| Variable | VIF | 1/VIF |
|----------|------|----------|
| BL | 1.79 | 0.557641 |
| DML | 1.76 | 0.567176 |
| AL | 2.64 | 0.609678 |
| SL | 1.55 | 0.646588 |
| Mean | 1.69 | |

Source: Research Data, 2018

As showed in table above for all variables the variance inflation factor (VIF) is significantly less than 10 and multi collinearity cannot be a problem in this model.

Heteroscedasticity Test

Here different response variables have the same variance in their errors, regardless of the values of the predictor variables. This assumption was tested by Breusch-Pagan /Cook-Weisberg test. The null hypothesis is that there is no constant variance or homoscedasticity if p-value is less than 0.05.

Table4. Regression Results of the Research Model

| Model | Expected Sign | Coefficient | Std. error | T | P-value |
|-------------------------|---------------|-------------|------------|-------|----------|
| Constant | | -.0240894 | .016534 | -1.46 | 0.000 |
| BL | + | .0078287 | .0014581 | 5.37 | 0.013** |
| DML | + | .0024443 | .0008511 | 2.87 | 0.001*** |
| AL | + | .0038139 | .0009468 | 4.03 | 0.010** |
| SL | + | .0074675 | .001242 | 6.01 | 0.022** |
| R- Squared0.5695 | | | | | |
| Adjusted R Square0.5632 | | | | | |

Source: Research Data, 2018

Multiple linear regression model:

$$Y_i = \beta_0 + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \beta_4 X_{i4} + e_i$$

Where;

Y_i = Financial performance (Dependent Variable)

$X_1 - X_4$ – Independent Variables

X_1 = Budgeting literacy

X_2 = Debt management literacy

X_3 = Accounting literacy

X_4 = Saving literacy

β_0 = Co-efficient of the model

e = Error Term

The overall model will be

$$Y = -0.2408 + 0.0782x_1 + 0.02444x_2 + 0.0381x_3 + 0.07467x_4$$

Breusch-Pagan Test for Heteroscedasticity

Variables: fitted values of ROA

$$\text{Chi2 (1) = 0.67}$$

$$\text{Prob > chi2 = 0.4134}$$

Here, since the p value is insignificant ($p > 0.05$) the researcher rejects the null hypothesis. It can conclude that there is constant variance or homoscedasticity.

REGRESSION ANALYSIS OF THE STUDY

The study applies multiple linear regression in analysis this paper. Multiple regression analysis assesses the degree and character of relationships between a dependent variable and independent variables in an objective way. The dependent variable for this thesis is Return on asset (ROA) whereas the four independent variables are BL, DML, AL and SL with regard to medium enterprises. Regression analysis can determine how much of the variation in the dependent variable can be explained by the independent variables. That is, the strength of the relationship. In regression analysis this is measured by R-Square (R^2).

The above Table provides R^2 and Adjusted R Square. The R^2 value 0.5695 indicates how much of the dependent variable could be explained by the independent variable. It shows that 56.9% of the financial performance was explained by the independent variable financial literacy which is large. The independent variables studied explain only 56.9% of the effects of financial literacy on the performance of medium enterprise in Hawassa City and 43.1% is explained by other factors.

DISCUSSION

This part of the research, concerned about major findings of the study with other relevant empirical concepts. The aim of this thesis is assessing the effect of financial literacy on financial performance of medium scale

Effect of Financial Literacy on Financial Performance of Medium Scale Enterprise; Case Study in Hawassa City, Ethiopia

enterprise in Hawassa city, by using financial performance as a dependent variable; and budgeting literacy (BL), debt management literacy (DML), accounting literacy (AL) and saving literacy (SL) as independent variables of the study.

The result of study shows that most of the respondents had inadequate knowledge on proper budgeting. This may be due to absence of formal training regarding budget to improve budgeting literacy of ME owners in Hawassa city. According to Mwaniki (2014) finding majority of respondents were keeping a written budget after the training. That means training improve budgeting literacy. From the finding it also understands budgeting literacy is significantly related with financial performance of medium enterprises. Thus high financial performance was related with having high budgeting literacy. Budget can be used as a means of better money management and controlling cost; that leads to increase the performance of business. However, the study finding indicates that majority of the respondents had no in depth knowledge on proper budgeting plan of written financial objectives to be realized in the business. Therefore, it can be said that the financial performance of those enterprises is not in a good condition.

The finding of the study also shows that majority of respondents lacked debt management literacy. This may be because of lack of financial education. The differences in financial knowledge across education groups indicate that financial literacy is highly correlated with education. More importantly, financial illiteracy is severe among those with no formal education (Abdeldayem, 2016). In this study, the reason for having inadequate debt management literacy may be because of majority of ME owner's not attained higher education. On the other hand the study also finds debt management literacy is significantly and positively related to financial performance. But, the finding showed that most medium enterprise has inadequate knowledge concerning debt management. Therefore, inadequate knowledge on debt concerns will cause debt overhang, which is nowadays the problem of many enterprises by its injurious effect on the health of their business. In this study financial performance of business is significantly influenced by debt management literacy. The high level of financial literacy regarding debt management enhances business performance.

This means a person who has knowledge to manage his/her debt in running business efficiently would have better financial performance.

The results of the study also revealed that majority of the medium enterprises encounter problems of lack of accounting knowledge; that most of the respondents do not have knowledge on proper recording daily transactions and prepare financial statements of the business (income statement, balance sheet), because they do not know how to keep such records in a formal way. This may be because of not getting trainings concerning accounting to improve their knowledge. The finding of the study shows that there is significant positive relation between accounting literacy and financial performance of MEs. Knowledge and skills in bookkeeping is especially one major factor that affects positively on viable and growth of business.

If enterprise owner do not keep complete accounting record, it is difficult for the businesspersons to calculate their business profit efficiently (Mutua, 2015). Adekunle, and Tajudeen, (2014) find that there is a strong relationship between accounting records keeping and performance of medium scale enterprises.

Finally, the finding implies that saving literacy has a positive relation with the financial performance. This is supported by Kimunduu, Erick and Shisia (2016) who revealed that personal saving skills are relevant in enhancing profitability of the medium enterprises. However, the result of analysis shows that majority of respondents have inadequate level of saving literacy. Scoring low level of saving literacy may be because of their age level. Because, majority of ME owners are aged between 18-30 age level. According to Chen & Volpe (2002), participants under age 30 are more likely to be less financially literate than those who are 40 and above.

These findings indicate that budgeting literacy, debt management literacy, accounting literacy and saving literacy have a positive relationship with financial performance and also have effect on financial performance of MEs in Hawassa city.

CONCLUSION

Based on the objective of the thesis and from the above findings, discussions and summary of the study the following conclusions are drawn. The

findings established that level financial literacy of owners has a positive significant effect on the financial performance of medium enterprises.

Financially literate owners in budget had obtained fruitful financial outcomes as compared to those owners who had in adequate financial literacy in its enterprises. This is because it helps them to reduce running costs and avoid unnecessary costs for proper utilization of resources of an enterprise. A business owner who prepared written objectives could reduce his/her cost by controlling excessive spending. Because, written budget gives them an opportunity to compare the expected expenditure with the real expenditure

Then if the business spending pattern is not as expected; it is in a position to understand the problems which makes this difference and can take corrective actions in order to avoid removable costs. Therefore, the study concludes that budgeting literacy has positive and significant effect on financial performance of medium enterprises. So, it is better if business owners practice budget by preparing written financial objectives.

Business owner with good level of debt management could come with better financial performance. Because, it help them to reduce costs related to borrowed money in terms of interest rate. Since it enables on how one can get loan at a minimum cost by comparing conditions and terms of financial institutions who lend money. And also help on repayment of loan on time; since delaying on payment will cause penalty that could increases the costs of business. Additionally, knowledge on how to manage the debt would help to separate business loan from personal loan; then it could not use business loan for personal consumption which would affect the business financial position. The researcher concludes debt management literacy has positive and significant effect on financial performance. As a result it is better if attention give on how to manage debts.

Successful businesses were related with owners who had good accounting literacy. As, a figure presented in the financial statements by enterprises show the position of business; which used to make important decision that was related and could be affected the performance of enterprise. Since business significant decisions are depend on information presented in financial statements without understanding and considering

the information presented in financial statements; it is difficult to make important decision; properly recorded business transactions including separation of business and personal records are inputs for preparation of complete financial statements. Consequently, incomplete or improper record keeping leads to have wrong picture of business operation. Therefore, the study concludes that accounting literacy has positive and significant effect on financial performance of medium enterprises. So it is better if business owners have effort to acquire accounting literacy.

A business owner with good saving literacy could earn better performance as compared to owners with low saving literacy. Because, saving would help owners in enhancing business financial position by increasing its asset; and it could be used as a means of source of finance in growing or expansion the business in the long run. In addition to that since future is unknown; the market environments are change through time by different reasons; it is essential to keep reserve money for this uncertainty. Saving is vital not only for accumulating wealth but also it is important in reducing business reliance on debt. Consequently, the researcher concludes that saving literacy has positive and significant effect on financial performance of medium enterprises. Thus it is better if business owners have saving literacy.

RECOMMENDATIONS

The government better to give attention to improve the level of financial literacy of medium enterprises.

- The researcher understands that there is lack of formal training in the study area for medium enterprises regarding financial literacy to improve its level. Therefore, the researcher recommended that, the government should prepare trainings on the issue of financial matters for enterprise owners to create the most informed and competitor business owner in the market.
- There is also lack of formal financial education in area. Therefore, education should be start at secondary school level. Henceforth people could be educated about financial matters as early as possible in their lives through including financial education in to educational curriculum.

RECOMMENDATION FOR FURTHER STUDY

- It is better if further study done by focusing on other variables which are not included in this research. Moreover, the study is carried out on selected medium enterprises in Hawassa city and the result of this study is limited to the views and insights of those enterprises owners. Therefore, the researcher encourage for other researchers to conduct the study within different enterprise owners in different part of the country.
- In addition to that to understand fully the effect of financial literacy in different angles, the researcher recommended for future researchers to address a non-financial measures.

REFERENCES

- [1] Abdeldayem, M.M. (2016). "Is There a Relationship between Financial literacy and Investment Decisions in the Kingdom of Bahrain?" *Volume 5, Issue 4 Pages: 203-221*
- [2] Adekunle, O.A, and Tajudeen A.A(2014) The Analysis of the impact of Accounting Records Keeping on the Performance of the Small Scale Enterprises. *Journal of Academic Research in Business and Social Sciences Vol. 4, No. 1ISSN: 2222-6990*
- [3] Adomako, S., and Danso, A. (2014). "Regulatory environment, environmental dynamism, political ties, and performance: study of entrepreneurial firms in a developing economy." *Journal of Small Business and Enterprise Development, Vol. 21, No. 2, 212-230*
- [4] Chen, H. & Volpe, R.P. 1998. "An analysis of personal financial literacy among college students." *Financial Services Review, 7(2):107-128.*
- [5] FDRE, (2011). "The federal Democratic Republic of Ethiopia: Poverty Reduction Strategy
- [6] Kamunge, M.S., Njeru, A. and Tirimba, O.I. (2014). "Factors Affecting the Performance of Small and Micro Enterprises in Limuru Town Market of Kiambu County, Kenya." *International Journal of Scientific and Research Publications, Volume 4, Issue 12.*
- [7] Kimunduu, G., Erick, O., and Shisia, A. (2016). "A study on the influence of financial literacy on financial performance of small and medium enterprises in Kenya."
- [8] Kothari, C.R. (2004). "Research methodology: Methods and techniques." *New Delhi: New Age International Ltd*
- [9] Kotzè, M.L Smit A.V.A. (2008). "Personal financial literacy and personal debt management: the potential relationship with new venture creation." *Volume 1, Issue 1.*
- [10] Kubiszyn, T. & Borich, G. (2013). "Educational testing and measurement: classroom application and practice"
- [11] Mandell L. (2008). "Financial Literacy of High School Students." *Hand book of consumer finance research pp163-183.*
- [12] Massimo, C. and Ornella, R. (2012). "The relationship between everyday practices and financial literacy. An empirical analysis:" *Volume 19 Number 1*
- [13] Miller, M. Godfrey N, Levesque, B. and Stark, E. (2009). "The case for financial literacy in developing countries: Promoting access to finance by empowering consumers." World Bank, DFID, OECD, and CGAP joint note, Washington, DC: World Bank
- [14] Mutua, R.K. (2016). "Impact of credit risk management on financial performance of savings and credit co-operative societies in Kitui County."
- [15] Mwaniki, S.M. (2014). "Influence of financial literacy training on financial performance of women self-help groups: a case of equity Bank customers, isiolo branch, Kenya "
- [16] Patrick, C. (2015). "The effect of financial literacy on performance of small and medium enterprises in Trans Nzoia Country .University of Nairobi."
- [17] Shiferaw, D. G. (2013): "Socio-economic Contributions of Micro and Small Enterprises: The Case of Jimma City." *Technology and Arts Research Journal, 2 (2): 123-134.*
- [18] Van Rooij M., Lusardi A., and Alessie Rob J. M. (2007). "Financial Literacy and Stock Market Participation."
- [19] Yamane, T. (1967) "Statistics 2nd edition, New work. Hayper and Row."

Citation: Leyla Jemal, "Effect of Financial Literacy on Financial Performance of Medium Scale Enterprise; Case Study in Hawassa City, Ethiopia", *International Journal of Research in Business Studies and Management*, 6(11), 2019, pp. 32-39.

Copyright: © 2019 Leyla Jemal. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.