

Impact of Financial Literacy on Firm Performance of Sri Lankan SMEs: Special Reference to Ratnapura District

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Introduction

Financial literacy is a vital factor to understand finance functions in organizations and to run an organization. Financial literacy is a combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and ultimately achieve individual financial wellbeing (Atkinson & Messy 2012). Substantially, in a well-established corporation, preparation of a financial statement is a mandatory legal requirement by legal bodies. In the case of Micro, Small and Medium size enterprises (SMEs), still do not have compulsory legislation for preparing the financial statements. SMEs are small in financial nature therefore, they face problems and issues regarding their sustainability, such as lack of a source of funds, unskilled labour and high competition (Chepngetich 2016). With lack of a source of fund and low level of financial literacy, SMEs face difficulties to prepare their financial statements (Mabhanda 2015). In addition, illiteracy may cause financial crisis (Atkinson & Messy 2012). Therefore, this study focuses on the impact of financial literacy on firm performance of Sri Lankan SMEs.

Research Problem and research question

Financial literacy is very important to both organizations and the general public. Several studies (Kimundun, Erick & Shisia 2016; Lusimbo & Muturi 2016; Fatoki 2014) indicate the relationship between financial literacy and SMEs performance in various countries and this level of financial literacy highly determine the firm performance. These findings prove that the organizations cannot achieve the highest growth without improving their financial knowledge. Generally, this problem significantly dominates to the SME businesses and its performance also. It is necessary to correctly identify the factors influencing financial literacy and the impact of financial literacy factors on the financial performance of SMEs. Therefore, the research question is:

What is the impact of financial literacy factors on the financial performance of SMEs in Sri Lanka?

The objective of the study

To investigate the impact of financial literacy on the financial performance of SMEs in Rathnapura District, Sri Lanka

Literature Review

Several definitions have been provided by different agencies to define the SMEs. But, there is no generally accepted definition in Sri Lanka. Therefore, according to the Ministry of Industries and Commerce, SMEs are identified as follows:

Table 1. Criteria of SMEs

	Criteria	Medium	Small	Micro
Manufacturing Sector	Annual Turnover (Rs' Million)	251-750	16-250	Less than 15
	No. of employees	51-300	11-50	Less than 10
Service Sector	Annual Turnover (Rs' Million)	250-750	16-250	Less than 15
	No. of employees	51-200	11-50	Less than 10

Source: Ministry of Industries and Commerce

Financial literacy refers the knowledge of money and financial products that people can apply to financial choices in order to make informed decisions about how to handle their finances (Basu 2005) and performance refers to the total economic results of activities undertaken by an organization, whether directly or indirectly (Lusch&Laczniak 1989).

Several researchers proved that there is a relationship between financial literacy and firm performance. Kimundun, Erick & Shisia (2016) proved that there was a positive relationship between financial literacy and performance. Chepngetic (2016) argued that the borrowing financial literacy negatively influences on financial performance and budgeting related financial literacy positively influence financial performance. Further, management with low financial literacy shows a minimal growth rate or no growth (Lusimbo& Muturi 2016).

Methodology

Dependent variable

Firm performance of the SMEs is considered as the dependent variable and they measured as Growth in sales in relation to owner expectations (GSO), Growth in

sales in relation to competitors (GSC), Growth in profits in relation to owner expectations (GPO), Growth in profit level in relation to Competitors (GSC), Increase in number of employees (NOE), Increase Fixed assets of the organization in relation to owner expectation (IFAO), and Increase Fixed assets of the organization in relation to competitors (IFAC).

Independent variables

Bookkeeping: Small businesses depend largely on their quality of accounting information. Therefore, bookkeeping as an indicator of financial literacy. This is measured by the preparation of financial statements (FS).

Financial planning budgeting and control: To use scarce resources, financial planning, budgeting and controlling have become important for the success of businesses. This is measured by financial objectives (FO).

Finance and information related skills and use of technology: Use of finance and information related skills support for the preparation of financial reports. It is measured by computer literacy (CL).

Risk management: To avoid risk insurance is important. Therefore, the risk is measured by business insurance (BI).

Understanding business terminology: Understand business terms such as interest rate, tax rate, inflation rate, investment will support the sustainability of the business. Understanding business terminologies (BT) are used as measures.

Understanding of Funding sources: SMEs should need well financial knowledge to choose the best funding sources for their success. This is measured by having a business bank account (BBA).

Hypotheses of the study

H₁: Bookkeeping has a significant impact on firm performance.

H₂: Financial Planning, budgeting and control has a significant impact on firm performance

H₃: Finance and Information Related Skills and Use of Technology have a significant impact on firm performance

H₄: Risk management has a significant impact on firm performance

H₅: Understanding of business terminologies has a significant impact on firm performance

H₆: Understanding of funding sources has a significant impact on firm performance

Population and Sample

SMEs were identified according to the definition of the Ministry of Industries and Commerce. Population includes 315 SMEs registered under chamber of commerce in Rathnapura and the researcher selected 100 SMEs by using convenience

sampling method. Selected SMEs are functioning in Ratnapura, Pelmadulla, and Balangoda Divisional secretariat located in Ratnapura district.

Questionnaires were distributed among SMEs and able to collect 100 questionnaires by discussing their financial literacy and firm performance from the selected sample during October 2017.

Method of Data Analysis

The rank order probit model was used to measure the impact of financial literacy on firm performance. Since the dependent variable has 5 point Likert scale with ordinal data. Therefore, the rank order probit model was used. The following model was created:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

ε

Y = Financial Performance, β_0 = constant, β_1 to β_6 are the coefficients of each independent variable and X_1 to X_6 are each independent variable.

Results and Discussion

There is a 58% owner or key person have accounting or financial related knowledge of the business. When referring the age of the SMEs most of them are newly started their business. This is 44% of the sample and which are running 1- 5 years. Among sample SMES, 30% of SMEs have been running their business, more than 20 years. According to the education level of the SMEs, most of them are studied up to Ordinary Level (O/L) and Advanced Level (A/L). Finally, all independent variable except funding sources has a significant impact on the financial performance of SMEs. Following Table 2 shows the results of the rank order probit model.

Table 2. Rank order probit model results

Dependent Variable	H ₁	H ₂	H ₃	H ₄	H ₅	H ₆
GSO	0.795***	0.536*	0.586**	0.746**	0.301	-0.375
GSC	1.122***	0.296	0.673**	0.481*	0.564**	-0.188
GPO	1.026***	1.030***	0.716**	1.043***	0.510*	-0.093
GSC	1.135***	0.479	0.548**	0.584**	0.888***	-0.577
NOE	1.259***	0.853***	0.45	-0.22	0.456*	0.439**
IFAO	0.863***	0.31	0.427	0.845***	0.570**	-0.005
IFAC	1.201***	0.797**	0.075	0.476*	0.913***	0.145

*, ** and*** represent the significant level at 10%, 5%, and 1% respectively

According to the above Table 2, the coefficients of each hypothesis are presented based on the rank order probit model. Bookkeeping significantly impacts on the financial performance of SMEs which were measured by GSO, GSC, GPO, GSC,

NOE, IFAO, and IFAC. Financial planning, budgeting and control impact on GSO, GPO, NOE, and IFAC, Finance and Information related skills and use of technology significantly impact on GSO, GSC, GPO and GSC, Risk management impact on GSO, GSC, GPO, GSC, IFAO, and IFAC, understanding business terminologies has impact on GSC, GPO, GSC, NOE, IFAO, and IFAC and understanding of funding sources significantly impact NOE. Based on these coefficient values, the hypotheses testing results are presented in the Table 3. \

Table 3. Hypotheses testing results

Dependent Variable	H ₁	H ₂	H ₃	H ₄	H ₅	H ₆
GSO	Accepted	Accepted	Accepted	Accepted	Rejected	Rejected
GSC	Accepted	Rejected	Accepted	Accepted	Accepted	Rejected
GPO	Accepted	Accepted	Accepted	Accepted	Accepted	Rejected
GSC	Accepted	Rejected	Accepted	Accepted	Accepted	Rejected
NOE	Accepted	Accepted	Rejected	Rejected	Accepted	Accepted
IFAO	Accepted	Rejected	Rejected	Accepted	Accepted	Rejected
IFAC	Accepted	Accepted	Rejected	Accepted	Accepted	Rejected

Conclusion

This study focused on identifying the impact of financial literacy on firm performance of SMEs. By using the rank order probit model it is identified that the financial literacy highly impacts on SMEs performance. Furthermore, the researcher selected financial literacy factors of bookkeeping, risk management, understanding business terminologies, finance related skills and use of technology, financial planning budgeting and controlling significantly impact on financial performance of SMEs respectively. Therefore, the study concludes that the financial literacy is an important factor to determine the firm performance.

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