THE IMPACT OF FINANCIAL LITERACY ON BUSINESS PERFORMANCE IN SMALL AND MEDIUM ENTERPRISES: EVIDENCE FROM KEGALLE DISTRICT IN SRI LANKA

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Abstract

This study has been conducted to achieve the objectives of examining the level of financial literacy based on demographic factors and identifying the impact of Financial Literacy on Business Performance of Small and Medium Enterprises (SMEs) in the Kegalle district of Sri Lanka. Thus, a quantitative study has been conducted based on Prospect Theory, and Exchange theory. There is a dearth of studies related to these variableswithin Sri Lanka. This study is carried out as a solution to the empirical gap. The sample size was 100 SMEs in the Kegalle district and the representative purposive sampling method used to collect the required information. This study has been used primary data through questionnaires after conducting factor analysis, reliability and validity test. The objectives have been achieved through descriptive analysis, correlation, and regression analysis since the past empirical review suggested using this analysis to examine the relationship. The findings of the study revealed that there is a positive relationship between financial literacy and business performance. Accordingly, independent variables such as technical financial knowledge, financial market knowledge & financial management skills have an effect on the business performance of SMEs and among these variables, technical financial knowledge and financial management skills are the most influential factors which affect the business performance. As the explanation of prospect theory, this study also concluded that there should have good financial knowledge among owners to make decisions. This study also concluded that owners or employees should have higher education level. As the explanation of exchange theory, it should exchange information or knowledge among employees and recruit more skilled employees. The research provides insight into the business owners of SMEs & policymakers that how they can make better decisions to improve business *performance through financial literacy. Accordingly, the business owners and policymakers should arrange training programs to improve the knowledge of financial literacy.*

Keywords: : Financial Literacy, SME's, Business Performance

1. Introduction

In today, Small & Medium scale Enterprises (SMEs) has become the major economic path of developing the Sri Lankan economy. Because Small and Medium Scale Enterprises (SMEs) are facilitators for entrepreneurship, employ ment, innovation, and so on. Small and Medium Scale Enterprises (SMEs) contribute mainly to domestic produ ction, employment in both developed and developing countries. Mostly SMEs employ more than 90 percent of formal and informal workers in the developing world (Page & Soderbom, 2015). Therefore the economy is highly depended on SMEs. Due to those things, the Sri Lankan Government can raise their income by taxes, reduce poverty and also reduce unemployment.

If SMEs contribute a high impact on the economy, they have many challenges. 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 (Chepngetich, 2016). So some of the time when an enterprise starts, it is collapsed as the result of a non-understanding of financial process& their complexity. Most of the SMEs do not know how to manage their money. Sometimes they borrow money from high-interest companies, spend all the money without considering future plans, invest in negative NPV real asset investments & so on. So they have to face much financial distress in the organization and to wind up the firm finally. Given in high failure rate, it becomes vital to research the factors required to enable the SMEs to survive & indeed progress to the growth phase of the organizational life cycle (Kamunge et al., 2014).

Accordingly, it is found that Financial Literacy has become the most important factor in day to day operations in every individual & business. Financial literacy refers to the knowledge of money & financial products that people can apply to financial choices in order to make informed decisions about how to handle their finances (Basu, 2005). Financial literacy has been shown to be essential in improving transparency, efficiency, accuracy & accountability resulting in the organizations achieving their objectives (Koitaba, 2013). Effective implementations of financial literacy skills lead to an improvement in business performance due to an improved ability to track business events from the record system (Siekei et al., 2013).

In the last decades, many types of research have concluded the positive relation between financial literacy & financial performance. Furthermore, financial literacy has become essentials in the running of business & operations of organizations in the complex & dynamic environment today. Scholars such as Schiffer and Weder (2001); Creessy (2002); Beck at al., (2008) have argued that the role of SMEs in economic development has been limited by lack of access to financial services, especially from formal financial institutions. This is due to the low level of financial literacy among SME owners & managers.

Many studies considered on financial literacy only focused on personal finance and fail to relate it to business perfor mance. Unlike the previous studies, this study focused on four various com ponents of technical financial knowledge, financial market knowledge, risk attitude & financial management skills and their affection on the business performance of SMEs in the Mawanalla region of Kegalle district in Sri Lanka.

Accordingly, The main objectives of this study are :
To examine the level of financial literacy based on demographic factors such as gender, age level, the monthly income level of SMEs, education level of owners, legal formation, and numbers of employees at the SME.

To examine the impact of the Financial Literacy on Business Performance of Small & Medium scale Enterprises in the Mawanalla region of Kegalle district in Sri Lanka. And also sub objectives of this study are :

1. To examine the relationship bet ween Technical Financial Knowledge and Business Performance of SMEs.
2. To examine the relationship between Market Knowledge and Business Performance of SMEs.
3. To examine the relationship between Risk Attitude and Business Performance of SMEs.
4. To examine the relationship between Financial Management Skills and Business Performance of SMEs.

Statement of the Problem

In every economy, SMEs play a crucial role in providing employment, contri buting GDP & innovation to countries. Sri Lanka has more than one million registered SMEs, each employing three persons on average (Census, 2017). Accordingly, Sri Lankan SMEs account for 52% of GDP (CBSL) and also contribute to more than 65% of employment.

However, SMEs' failure rate has increased rapidly due to some of the reasons. The major problem is that they do not know how to manage their finance to get the maximum profit for achieving their objectives and surviving. It was reported that the rate of business failure among SMEs is 45% (Daily Mirror, 2016). It also revealed that the major causes for that failure are lack of level of education of business owners, prior business planning, financial knowledge & skills, and inappropriate finance.

In this regard, to achieve the objectives which are indicated how the financial literacy effects on the business performance of Small & Medium-scale Enterprises (SMEs) in Mawanalla region of Kegalle district in Sri Lanka is targeted to fulfil the present research gap. Accordingly this study, therefore, seeks to examine the effects of measurements of financial literacy towards the business performance by using financial variables such as technical financial knowledge, financial market knowledge, risk attitude & financial management skills.

2. Methodology

This study used the positivism approach, deductive method, and quantitative method to measure the effect of financial literacy on the business performance of SMEs. As the method of data collection, the primary data through questionnaires were used and selected 100 of SMEs as sample in the Mawanalla region, Kegalle district, among registered SMEs in this area. And also to measure the reliability of the questionnaires, it was conducted Cronbach's alpha test and to measure the validity of the questionnaires, it was conducted factor analysis. Questions which are greater than 0.5 by considering the communalities table of factor analysis were used to further analysis.

The primary objective of this study is to measure the effect of financial literacy on the business performance of SMEs and to examine the level of financial literacy. The data collected hasanalyzed with the software of Statistical Package for Social Sciences (SPSS 20) because it has clarity, preciseness, ease of understanding, and interpretation. This study used descriptive analysis for that purpose and accordingly it was used mean, median, mode & standard deviation. In addition to this, this study used one way ANOVA to test whether there is a difference in business performance according to demographic factors such as age, gender, education level, income level, and so on.

In addition to this, the correlation has used to measure the relationship between the independent variables - technical financial knowledge, financial market knowledge, risk attitude & financial management skills, and the dependent variable – business performance.

To measure the relationship between financial literacy and business perfor mance, it has used the multiple linear regression analysis in this study. Before that, this study haschecked some assumptions.

Linear relationship – whether there is a relationship between independent variables and dependent variable.
Multivariate normality – whether the residuals are normally distributed.
No multicollinearity – whether the independent variables are not highly correlated with each other
Homoscedasticity – whether the variance of error terms are similar across the values of the independent variables.
Accordingly the regression model is as follows.

$$\mathrm{BP} = \alpha + \beta 1\ TFK + \beta 2\ FMK + \beta 4\ FMS + \varepsilon$$

BP = Business Performance
TFK = Technical Financial Knowledge
FMK = Financial Market Knowledge
FMS = Financial Management Skills

3. Results & Discussion

At initially, normality test has been conducted and accordingly outliers of sample has been reduced. The reliability values for variables such as technical financial knowledge, financial market knowledge, financial management skills and business performance were 0.793, 0.771, 0.852 and 0.865 respectively. Since the Extraction values from factor analysis for all questions are higher than 0.05, the validity was met.

Table 1: Correlations

		TFK	FMK	FMS	BP
TFK	Pearson Correlation	1			
	Sig. (2-tailed)				
FMK	Pearson Correlation	.504**	1		
	Sig. (2-tailed)	.000			
FMS	Pearson Correlation	.581**	.229*	1	
	Sig. (2-tailed)	.000	.041		
BP	Pearson Correlation	.659**	.326**	.815**	1
	Sig. (2-tailed)	.000	.003	.000	
	N	80	80	80	80

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

Using Pearson's product-moment correlation with a 2-tailed test of significance, the correlation analysis has made to investigate the relationship between the technical financial knowledge, financial market knowledge, financial management skills, and the dependent variable – business perfor mance. Table 1 illustrates the correlation analysis. Accordingly there is a positive relationship between these three independent variables on business performance of SMEs.

In this study, the R-Square value is 0.718, which means 71.8% of the variation in business performance can be explained by the independent variables. And also since the F test is significant, the overall regression model is statistically significant.

Table 2: Regression

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	4.882	3.152		1.549	.126		
	TFK	.296	.099	.253	2.993	.004	.517	1.933
	FMK	.095	.141	.048	.674	.503	.740	1.351
	FMS	.873	.100	.657	8.745	.000	.657	1.522

a. Dependent Variable: BP

Table 2 illustrates the influence of most critical factors of financial literacy dimensions and business performance. Since the p-value for technical financial knowledge is 0.004, technical financial knowledge is a significant predictor of business performance. But the p-value for financial market knowledge is 0.503, financial market knowledge is not a significant predictor of business performance. So this variable is removed from the model. Also since the p-value for financial management skills is 0.000, financial market knowledge is a signifi cant predictor of business performance. Accordingly, the regression equation is:

Business Performance = 4.882 + 0.296 TFK + 0. .873 FMS

Here,

TFK = Technical Financial Knowledge

FMS = Financial Management Skills

4. Conclusion(s)

This study can conclude that financial literacy is positively related to the business performance of the SMEs in Mawanalla region. Also, the conclusions drawn from this study revealed that there is a positive relationship between three independent variables – technical financial knowledge, financial market knowledge, and financial management skills on the business performance of SMEs. However according to the findings, among these variables technical financial knowledge and financial management skills are the most influential factors which affect business performance. Financial market knowle dge is not essential to the improvement of the business performance of SMEs. Therefore, high levels of technical financial knowledge and financial management skills among employees in the organization imply higher financial returns for the SMEs. An increase in technical financial knowledge and financial management skills will be increased financial returns by 72%.

The study can also conclude that SMEs' monthly income level, owners' education level, the legal formation of SMEs, and the number of employees are the major factor of influencing the level of financial literacy. Also it can be recommended that all the business organization and government should organize financial education programs and training programs to create awareness and improve knowledge on finance matters.

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