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RESEARCH ARTICLE

FINANCIAL LITERACY OF OWNER MANAGER AND FIRM PERFORMANCE OF SMES: A REVIEW ON CONCEPTUAL AND PRACTICE PERSPECTIVE

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ABSTRACT

Financial Literacy has been identified as a one of the key competencies required for the establishing, management and thriving of SMEs. However, the exact effect they have on the performance of SMEs has not been fully established by the available literature. This paper attempts to review the relationship between financial literacy of owner manager and firm performance of SMEs. Accordingly, the paper investigates the concepts, theories and previous research findings in relation to financial literacy of Owner Manager and firm performance of SMEs. Through the review on the available literature, it was revealed that the generally accepted relationship between financial literacy of Owner Manager and firm performance has not been found resulting in future research requirements.

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INTRODUCTION

The performance and growth of Small and Medium 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 and Entebang, 2014). Governments worldwide have recognized SMEs for their contribution to the economy stability and growth, employment and new job creation, and social cohesion and development (Morrison *et al.,* 2003; Santarelli and Vivarelli, 2007). SMEs makeup a large part of many economies. They are considered as the backbone of an economy given the fact that in some economies SMEs contribute to more than 50% of Gross Domestic Product (ACCA, 2010). Particularly in the European Union, SMEs constitute 99.8% of all firms and employ around 76 million people representing around 67.4% of total employment in 2010 (Ayyagari *et al.,* 2011). In the US, SMEs constituted to more than 50% of the non-farm private GDP and created 75% net new jobs in the economy (ACCA, 2010).Therefore, it is clear that SMEs play an important role in promoting inclusive growth in countries. As Pandya (2012) stated that the term "SME" covers a wide range of definitions. From country to country the definition may vary. In a usual viewpoint, these guidelines have been built focusing on the either headcount or sales or assets. According to National Policy Framework for SME Development, Ministry of Industry and Commerce, The Government of Sri Lanka recognizes SMEs as the backbone of the economy, as it accounts for more than 75% of the total number of enterprises, provides 45% of the employment and contributes to 52% of the Gross Domestic Production (GDP).Financial literacy is termed as the understanding and knowledge of the financial principles needed to make informed financial decisions and products which impact one's financial wellbeing (Basu, 2005). It includes the ability to make informed judgments and to take effective decision regarding financial matters (Worthington, 2005; OECD 2005) also adds on stating that financial literacy must involve not only the investors but also the customers, both having the knowledge of financial products and concepts and their ability to consider financial risks in their decision making and to make other effective actions to improve their financial. Firm performance refers to the total economic results of activities undertaken by an organization, whether directly or indirectly (Lusch and Laczniak, 1989). It is the efficiency and effectiveness of the organization (Letting, 2009). Specifically, financial performance of a firm determines how well the business is doing in wealth creation and acquiring of resources (Komppula, 2004). To measure financial performance, varied measure approaches have been adopted by various researchers including sales revenue, profits, return on investment/ equity (Wijewardena *et al.,* 2004; Colvin 1991) provide various financial measures which include sales level, sales growth rate, cash flow, return on shareholder equity, gross profit margin, net profit from operations, and ability to fund business growth from profits. The researches had been carried out to investigate the relationships between the financial literacy of owner manager and firm performance of SMEs. The results revealed a significant relationships between the different dimension of financial literacy and firm performances. Thus, the findings prove that financial literacy plays significant role in improving business performance (Kumar and Naidu 2017; Mutiso and Muigai 2018; Usama and Yusoff, 2018). Therefore, the owner managers need to improve their financial literacy skill in order to enhance their firm performances.

Purpose of study: Over the last two decades, scholars and policy makers in both developed and developing countries have recognized that financial literacy is critical for the establishment and survival of small businesses (Wise, 2013). The exact role of financial literacy on performance is what the scholars have tried to determine. Financial literacy is theorized to influence positively the performance of SMEs. Various theoretical perspectives have informed the debate on firm performance. Resource-based theories argue that a firm's resources and capabilities are the fundamental determinants of performance (Peteraf *et al.,* 2003). In order to manage these resources effectively, one has to be financially literate. From these speculations, the firm's performance is highly dependent on financial literacy. Empirically, studies have also confirmed the positive association between financial literacy and financial performance (Oseifuah, 2010; Dahmen and Rodríguez, 2014; Kumar and Naidu, 2017). Therefore this paper attempt to investigate how financial literacy of owner manager affect the performance of SMEs and its relationship through the theoretical as well as empirical perspectives. Additionally, this paper contributes to existing knowledge as a conceptual review to synthesize how financial literacy and firm performance is researched and claimed in future research direction.

MATERIALS AND METHODS

In this paper, fallows deductive approach in which the arguments and explanations are mainly supported by empirical evidences and associated theoretical contents. Further, Author reviewed the journal articles and industry publications to review the definitions, concepts, methods, theories and practices relating to financial literacy and firm performances. Accordingly, literature review was used as the main research tool. The Paper attempted to discuss its effect and relationship between financial literacy of owner manager and firm performance of SMEs by reviewing the findings of previous researches. Paper is organized as concept paper whist arguments were empirically supported. Finally, author conclude the paper by postulating future research direction.

THEORETICAL REVIEW ON FINANCIAL LITERACY OF OWNER MANAGER AND FIRM PERFORMANCE OF SMES: The researchers found that there is no any universally accepted definition in respect of financial literacy. Further, it was understood that there is no any universally accepted model to measure the financial literacy. The researchers found that the successful mechanism has been developed by Atkinson and Messy (2012) to measure the financial literacy. Atkinson and Messy (2012) highlighted that a lack of financial knowledge amongst a sizeable proportion of the population in each of the countries surveyed. Further, there is considerable room for improvement in terms of financial behavior. Attitudes are shown to vary widely. Lusardi and Mitchell (2009) demonstrated strong links between financial knowledge and financial behavior. They reported that how they collect the information for making these decisions, and whether they possess the financial literacy needed to make these decisions. Eniola and Entebang (2016), in their paper, financial literacy elaborated as " conceptually of how firms manage and strategize financial knowledge, which significantly affect decision makers' behaviors, awareness and attitudes, concerning sound decision making and eventually achieving organizational performance". Kumar and Naidu (2017) explained financial literacy is the ability to understand how money works in the world: how someone manages to earn or make it, how that person manages it, how he/she invests it (turn it into more) and how that person donates it to help others. The underpin theories on financial literacy includes Exchange theory, Transaction theory and Prospect theory. Exchange theory as proposed by Robson and Ladner (2006) holds that interpersonal, interactional, procedural and informational factors are linked to literacy skills. Hence, the higher the interactions, the higher the level of literacy the individual will have. Lusardi and Mitchell (2007) also supported this theory by their findings which indicated that financial literacy is higher among those who are working, and in some countries those who are self-employed as compared to those who are not working. Transaction theory as described by Polski *et al.* (2001) holds that organizations incur costs as they acquire, configure and utilize resources. This transaction costs reflect the costs of economic or organization both outside the firm and inside the firm. In addition to that, they are means by which one can measure the efficiency of different institutional designs in achieving economic outcomes in particular environments (Polski *et al.,* 2001). In order for an individual to effectively manage transactions, they ought to have financial management skills. Using the transaction theory framework, lack of financial skills will cause an increase in transaction costs, influencing negatively the performance. Prospect Theory was developed by Kahneman and Tversky, (1979) and it holds that decisions pertaining to financial matters of organizations are always between alternatives that involve risks where the probabilities are known. Prospect theory therefore speculates that before the owner makes any financial decision, he/she has to consider majorly the risks involved. This theory therefore holds that decisions made by owners should be done with some level of expertise, and this requires financial literacy knowledge. Resource Base View (RBV) theory argues that a firm resources and capabilities are fundamental determinants of performances (Peteraf, 2003). The main idea of the RBV is that a firm can achieve sustained competitive advantage and eventual superior growth and performance if it acquires and controls valuable, rare, inimitable and non-substitutable resources and capabilities, as long as it has the ability to absorb and apply them (Barney, 1991).

EMPIRICAL REVIEW ON FINANCIAL LITERACY OF OWNERMANAGER AND FIRM PERFORMANCE OF SMES: During the past, many empirical studied were carried out to investigate the relationship between financial literacy of owner manager and firm performances. Oseifuah (2010) called for a research into the level and impact of financial literacy on youth entrepreneurs. This research found that increases in financial literacy led to more frequent production of financial statements. One can hardly produce financial statements without being financially literate; further, a lack of comfort with financial matters (e.g., financial literacy) would correlate to dismissing the use of such. According to Dahmen and Rodríguez (2014), there were a clear connection between lack of or inadequate financial literacy and financial difficulties experienced by entrepreneurs. The general pattern of inadequacies documented by Lusardi (2012) and Gilliland *et al.* (2011) with respect to debt and money management among consumers is apparently paralleled by comparable deficiencies for entrepreneurs. This association between inadequate financial literacy and avoidance of the financial statements was a recurring theme and it attests to the connection between financial literacy and overall business success. In the study, Olawale Fatoki (2014) concluded that the failure rate of new micro enterprises is very high in South Africa. Financial literacy impacts positively on the ability to make good financial decisions and household well-being and business survival. The objective of the study was to measure the level of financial literacy of the owners of new micro enterprises. This study used financial planning, analysis and control, bookkeeping, understanding of funding sources, business terminology, finance and information skills, access to technology and risk-management to measure the financial literacy of entrepreneurs. Eniola and Entebang (2016), their research was based on resource based view theory to show the influence of financial literacy on the performance of small and medium enterprises (SMEs) in Nigeria. The resource-based theory is a basis of much what is taught today.

The performance of SME firms leads to some critical issues and many studies dealt with the subject matter from many angles. This study discussed one of the important issues: financial literacy would a particular problem of small and medium enterprises (SMEs), company tend to have much higher rates of job growth, but also are more likely to go out of business or remain stunted due to institutional and financial literacy problems. Kimunduu, Erick and Shisia (2016), in their study focused on the influence of financial literacy on financial performance of small and medium enterprises in Kenya and established that financial literacy improves financial performance of SMEs. As per Kumar and Naidu (2017), financial literacy has positive impacts on entrepreneurs to make good financial decisions and business survival. The main objective of their study was to measure the level of financial literacy awareness of the owners. There were a total of 50 randomly selected SMEs from different business sectors (manufacturing, transport, wholesale/retail, tourism and agriculture). Their study used financial planning, analysis and control, book keeping, understanding of funding sources, business terminology, finance and information skills and access to technology to measure the financial literacy of entrepreneurs. Mutiso and Muigai (2018) found that financial literacy skills contribute significantly to the performance of SMEs. A positive and significant relationship has been established between financial literacy skills and the performance of SMEs. Osinde *et al.,* (2013) observed that entrepreneurs who received business development skills recorded an improvement in the growth of their sales.

These findings concur with the views financial researchers such as Atkinson and Messy (2005); Remund (2010); Nyamboga et al (2014); Eniola and Entebang (2016) among others who argued that financial literacy is and should be taken as a crucial tool for SME performance. Financial literacy skills help investors to understand the financial products and services which give them the confidence to face financial risks and opportunities by making more informed decisions. Winarno and Wijijayanti (2018) in their study proved that entrepreneurial financial literacy does not influence the performance of small-medium enterprises in Batu East Java. The knowledge possessed by small-medium enterprises business actors in Batu regarding risk aspect is considered high or good, while knowledge regarding functional aspect is moderately good. The moment the small-medium enterprises business actors possess knowledge regarding business and entrepreneurship, it does not automatically guarantee neither the success nor failure of the business. Sana Shawl (2018) revealed that financial literacy has an impact on financial access which in turn influences the performance of firm. There are many factors contributing to limited access to financial services in developing countries, lack of financial literacy has been identified as one such factor.

Conclusion and further research directions

While reviewing the available literature, the author found that the generally accepted relationships have not been invented between financial literacy of Owner Manager and firm performance of SMEs. The similar type of researches had been carried out in few different countries. Few previous researchers found that there were positive significant relationships between financial literacy and firm performance of SMEs. Few researchers found that relationships between financial literacy and business performance of SMEs were not significant. Some researchers had argued that the Financial Literacy of Owner Manager had no effect to the firm performance of SMEs. Further it was found that there are lack of concepts and theories in respect of area to be researched and previous researches and literatures are limited in the selected area of research to be done. It was further revealed that the similar type of research had been carried out only in few counties and directing future research requirement in this area of interested.

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