

Financial Literacy and New Venture Performance in Developing Economies

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Abstract: The level of financial literacy in developing countries is lower and running a business exposes owners/managers to distinct challenges to manage. The need for financial literacy in developing countries has been emphasized by many scholars. Financial literacy is considered as an antidote for the growth and performance of new ventures especially in developing economies where most entrepreneurs lack financial knowledge in running businesses. This paper was carried out to ascertain the effect of financial literacy on the performance of new ventures in developing economies with particular reference to Nigeria. The study reviewed different literatures on the subject matter and most studies established a significant relationship between financial literacy and business performance. The studies also showed that financial literacy significantly influence the survival and growth of small scale businesses. This study therefore concludes that financial literacy is considered as a catalyst that helps entrepreneurs to face stiff competition by constantly making informed decisions to produce quality products to meet customers' needs in the market.

Keywords: Financial literacy, New Venture Performance, Small and Medium Scale Enterprises

1.1 Introduction

Small and medium scale enterprises are regarded as the cornerstone for growth, industrialization, employment generation, resource mobilization, income distribution, poverty reduction and economic development in both developed and developing nations. Small and medium scale enterprises have continued to play significant roles in employment generation, income distribution and poverty reduction in both developed and developing countries (Kpelai, 2009). In both developed and developing countries, the development of small and medium scale enterprises is very fundamental. The contribution of small and medium scale enterprises contributes to employment generation, economic growth and GDP of every country cannot be overemphasized. In Nigeria, the contribution of SMEs is substantial in terms of job creation, income generation, rural development, GDP and socio-economic development (Idowu, 2010). Given the increased complexity of day-to-day financial transactions, the evidence of illiteracy does not only raise important questions for policy but also has implications for household and firm financial behaviour.

Considering the role of SMEs and entrepreneurs in the developing economy, where by the highest percentage of the economy is controlled by these firms. Financial literacy as one of the key driver to the success of businesses is of big concern. In light of the changing business environment, financial literacy is considered to be the capability to adequately oversee financial resources over the business lifecycle and connect effectively with financial products and services (Lusardi & Mitchel, 2011). The increasing number of studies related to business literacy training for entrepreneurs reflects current political and economic standpoints which recognized the importance of business literacy for economic development. Literature find two reasons for this: (1) large number of people in developing countries make a living from small enterprises, unlike developed countries, where the majority of population are wage and salary workers; (2) recent studies note the importance of "managerial and business skills", as the key driver of enterprise growth and productivity, along with already known factors, such as access to the capital and external financing (Bruhn & Karlan, 2010; Bloom, Mahajan & McKenzie, 2010).

The management of firm financial resources requires knowledge, skill, attitude and experience with the goal to dealing with the survival of the firm, profit maximization, sales maximization, capturing a market share, minimizing staff turnover and internal conflicts; and maximizing wealth. Unfavorable business environment and high interest rates which make efficient use of borrowed funds more difficult increase the significance of business and financial training, especially in developing countries. It is clear that business training programs have the potential not only to improve individuals' living standard, but also to promote economic growth. Most small scale businesses are faced with problems such as finance, managerial skills, poor recording keeping and debt management as well as poor budgeting and planning. Some business owners also have poor saving culture and no knowledge of funding or source of finance which affects the performance of their businesses. Tellingly,

financial literacy or financial education has become a necessity for the survival of every new venture or entrepreneur.

The level of financial literacy in developing countries is however lower and running a business exposes owners/managers to distinct challenges to manage. According to Mba and Cletus (2014) observed that most Nigerian small business owners have poor investment culture of retain earnings and only few of them have the attitude of a typical entrepreneur of investing today and gain tomorrow. They argued that these challenges have been further compounded by owner-managers or operators taking loan for expansion or starting a new venture but only to turnaround to other non-profitable activities which resulted to serious difficulties in financing much needed working capital and this is most frequently mentioned as a problem of SMEs. Mba and Cletus (2014) further observed that majority of the small business operators in Nigeria lack adequate knowledge regarding marketing techniques, branding, customer loyalty and lack of good contacts with others local and international enterprises. They also asserted that the absence of trained manpower and operational competencies and skills among owner-manager constitute the primary challenges to the survival of SMEs in Nigeria.

Financial literacy involves the understanding of both basic financial concepts and the ability and discipline to use that information to make wise personal and financial decisions. These decisions include when to spend, when to save, effectively managing a budget, choosing the right financial products and readiness to address other life events. Financial literacy skills enable individuals to pilot the financial world, make informed decisions about their money and minimize their chances of being misled on financial matters (Beal & Delpachitra, 2005). In a study on the effect of finance on the survival of small business in Sri Lanka, Abiola (2011) established that financial literacy improved the usage of financial products by the enterprises, which in turn improved their survival. Nunoo and Andoh (2012) in their study on utilization of financial services by SMEs in Ghana established that financially literate entrepreneurs were more exposed to access and employ financial product which potentially improved the survival of their small enterprises. A study by Avlijaš, Avlijaš and Milenko (2014) on financial literacy as a factor in reducing entrepreneurial risk also indicates that financial literacy contributes to the growth and improvement in business operation, thus increasing competitiveness and entrepreneurship risk alleviation. Indeed, there is substantial evidence in small business survival literature which shows that poor financial literacy discourages entrepreneurs from seeking financial services and high financial literacy enhance consumption of financial services which improve profitability that significantly influence survival rate of small business. Financial literacy is thus recognized as a key factor influencing the survival and performance of both new and existing ventures (Rahmandoust et al. 2011; Xu & Zia, 2012; Sean, 2013; Cherugong, 2013; Musie, 2015).

1.2 Problem Statement

Financial literacy is considered an important adjunct for promoting financial inclusion and ultimately, financial stability. Both developed and developing countries, therefore, are focusing on programs for financial literacy/education. According to Brubn and Zia (2013) firms in developing countries are widely known to face many constraints, from lack of access to finance and physical capital to poor infrastructure. Recently, however, there has also been a growing focus among researchers on “managerial capital”, or business skills, as an important determinant of entrepreneurship in developing countries. Policymakers have been equally interested in the perceived deficit of managerial capital, and have been pouring resources into financial and business literacy education programs around the world. The need to identify inherent factors affecting the performance of new ventures have informed the decision by individuals and the government in bringing numerous initiatives and investments in training programs that should provide financial and business skills improvement for entrepreneurs. In Nigeria, government agencies and private organizations especially financial institutions have invested momentous resources in financial literacy programmes. The aim of these initiatives is to embolden entrepreneurs to make informed financial decisions in their businesses. However, it can be found that most entrepreneurs have not performed optimally some entrepreneurs are inept in making sound financial decisions in their businesses. The objective of this paper is to examine the effect of financial literacy on new venture performance. To achieve this objective, the paper is divided into introduction, literature review and conclusion.

2.1 Literature Review

2.1.1 Financial Literacy

Financial literacy is the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being. Financial literacy refers to the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources. It entails the knowledge of properly making decisions pertaining to certain personal finance areas like real estate, insurance, investing saving tax planning and retirement. It also involves intimate knowledge of concepts like interest rates financial planning, time value for money, borrowings and savings profit and loss assets and liabilities etc. In the world all

over, financial literacy has been given a lot of attention and is believed to be a key ingredient to personal finance success and entrepreneurship; it is relevant to anyone who makes decision about money (Musie, 2015). Financial literacy is the confluence of financial, credit and debt management and the knowledge that is necessary to make financially responsible decisions that are integral to everyday lives. [Financial literacy](#) includes understanding how a [checking account](#) works, what using a [credit card](#) really means, and how to avoid debt. In sum, financial literacy impacts the daily decisions an average family makes when trying to balance a budget, buy a home, fund their children's education and ensure an income at retirement. Financial literacy enables businesses to make informed decisions as far as money matters are concerned thus they can borrow, save and invest wisely. Financial literacy gives an individual or business owner the ability to make informed and effective decisions regarding management of money through understanding and application of financial concepts (Sucuahi, 2013). Financially literate SME owner/manager is defined as someone who knows what are the most suitable financing and financial management options for his/her business at various growth stages of his/her business; knows where to obtain the most suitable products and services; and interacts with confidence with the suppliers of these products and services. He/she is familiar with the legal and regulatory framework and his/her rights and recourse options (Mabula, 2013).

2.1.2 New Venture Performance

New venture performance according to Kpelai (2009) include the development and implementation of new venture strategy, the nature of the external environment munificence and industry structure, the accumulation of resources, building of an organization including developing distinctive competences, establishing support networks for entrepreneurs, capturing customer and establishing an organization culture and values. While the entrepreneurial activities are not sufficient condition to remain in the entrepreneurship paradigm, it is inherent in reaching self-sustenance. When an enterprise reaches self-sustainability, it exist the entrepreneurship paradigm. At that time, the enterprise is generally not dependent upon the founding team, risk has been substantially reduced, sustainable competitive advantage(s) have been created and a formalized organization established. The new venture must have also achieved financial success sufficient to fund its growth stage. More so critical success factors that promote firm's sustainability need to create the enabling environment in order to enhance the new venture performance and success (Kpelai, 2009).

2.1.3 Financial Literacy and Business Performance

Several studies have examined the relationship between financial literacy and business performance with mixed results. A study by Timmons and Spinelli(2007) found that increases in financial literacy led to more frequent production of financial statements. The lack of knowledge of financial management contributes to the low prevalence of new venture creation, and ultimately the high failure rate of Small and Medium-sized Enterprises (SMEs), as most entrepreneurs are intimidated by financial management. The research further shows that entrepreneurs, who produced financial statements more frequently, tended to default on their loans less and had less likelihood to close their venture involuntarily. One can hardly produce financial statements without being financially literate; further, a lack of comfort with financial matters (financial literacy) would correlate to dismissing the use of such. An increase in financial literacy of young entrepreneurs was found to increase the probability of loan repayment amongst new ventures. Similarly, a study by Oehler, Höfer and Schalkowski(2012) on entrepreneurial literacy in South Africa found that potential business founders evaluate schools' imparting of relevant knowledge for entrepreneurs as rather moderate. Musie (2015) examined the use of financial literacy concepts by entrepreneurs in the small and medium enterprise sector in Mpumalangan province, South Africa. The results of the study indicated that most of the SMEs did pursue all the three financial literacy concepts in managing their business finances. Furthermore, the study revealed that entrepreneurs lacked the knowledge regarding other source of capital such as venture capitalist funds and government agencies. The study also provided evidence of a positive relationship between the use of financial literacy concepts and the economic success of SMEs. Greenspan (2002) also argues that financial literacy helps to inculcate individuals with the financial knowledge necessary to create household budgets, initiate saving plans, and make strategic investment decisions. Proper application of that knowledge helps investors to meet their financial obligations through wise planning, and resource allocation so as to derive maximum utility. Additionally, Cherugong (2013) established that there was a positive strong effect of financial literacy on SMEs performance in Kenya. Increases in financial literacy leads to more frequent production of financial statements. Also, entrepreneurs who produce financial statements more frequently have a higher probability of loan repayment and a lower probability to close their venture involuntarily. Financial literacy is therefore a necessity for all entrepreneurs in Canada (Sean, 2013). In another study, Njoroge (2013) found that all the SMEs interviewed were found to have some level of financial literacy and on average most entrepreneurs scored well above average in financial literacy. Highly successful entrepreneurs scored highly in financial literacy and

demonstrated high understanding of finance. In contrast, less successful entrepreneurs exhibited stagnant growth, and low level of financial literacy majority of who were found to be in informal sector. The study concluded that there was a positive relationship between financial literacy and entrepreneurial success in Nairobi County. According to Drexler, Fischer and Schoar (2010) individuals and micro-entrepreneurs often lack sufficient financial literacy to make the complex financial decisions they face. Tuyisenge, Mugambi and Kemirembe (2015) findings indicated that skills regarding to the maintenance of debtors and creditors ledgers increased after financial literacy training and this had a positive effect in business in terms of expansion prospects. They however, pointed out that the quality of financial information available for financing institutions is rather poor. It also indicated that credits decisions become difficult and collateral requirements as well as interest rates are high, substantially aggravating access to credit and controlling the loan Book was equally difficult. A study by Chepkemoi (2007) on the effects of financial literacy training on business profitability of SMEs in Coastal region Kenya established that financial literacy training positively influenced the performance of SMEs and profitability. The study concluded that financial literacy affected profitability of SMEs. Oseifuah (2010) suggests that increased financial literacy leads to better decision making or increased financial responsibility.

3.1 Conclusion and Recommendations

The review of previous studies shows that there is increase in financial literacy by entrepreneurs and business owners. Many studies have established that financial literacy not only helps to inculcate individuals with the financial knowledge necessary to create household budgets, initiate saving plans, and make strategic investment decisions but proper application of that knowledge helps investors to meet their financial obligations through wise planning, and resource allocation so as to derive maximum utility. Developing financial behaviour is therefore considered as an antidote for the growth and performance of new ventures especially in this era. Financial literacy will help them to face stiff competition by constantly making informed decisions by producing quality products to meet customers' needs. The knowledge of financial literacy also assists entrepreneurs to overcome challenges in accessing fund and expose them to better decision making skills that lead to borrowing, savings, investment, risk taking and proper record keeping. It is therefore recommended that authorities in charge of providing financial literacy programmes should consider implementing programmes which fits the culture and traditions of the context targeted entrepreneurs since different SMEs have different experiences. In order to improve their financial knowledge, entrepreneurs should develop networks within them to share knowledge, skills and best practices on financial management. Educational institutions should also teach topics on financial literacy. Lastly, government should provide training to entrepreneurs so as to improve their financial knowledge which will help in business expansion. It is suggested that further studies should be carried out on government policies and programmes that encourage small scale businesses to develop financial knowledge.

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