Financial literacy and the growth of Small Medium size Enterprises: An analysis of Enterprises in the UK

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Introduction

- Empirical evidence demonstrates the importance of SMEs ecosystem for an efficient and competitive functioning economy.

- SMEs make contribution towards:
  - Employment
  - Provide economic agility and facilitates innovation
  - Contribute towards a cohesive and progressive economic structure of economies (Hussain and Matlay, 2007)
  - SMEs are the dominant entities world over (Kheng and Minai, 2016).

- According to Federation of Small Business Survey 2016 SMEs in the UK account for:
  - 99.9% all private businesses
  - Over 60% of employment and over 45% of all business turnover
  - World over account for 70% of GDP and more than 95% of workforce

- SMEs are inherently agile, rapidly respond to changes and adapt to innovation (Audretsch et al., 2009; Carter and Jones-Evans 2006)

- Given the importance, it is not surprise that there is a major occupation amongst policy makers, entrepreneurs, governments and academics about the access to finance for SMEs in the UK (Kheng and Minai, 2016)
Theory and prior evidence

• SMEs encounter finance constraint (MacMillan Committee 1931; Ackerlof, 1970; Deakins and Hussain 1994; Hamilton and Fox, 1998; Brown and Lee, 2016)

• To mitigate information asymmetry, lenders often seek collateral (Imronudin and Hussain, 2016, Deakin and Hussain, 1994; Fletcher 1994; Cowling et al., 2016) and set higher charges (Berger and Udell, 1998)

• A pool of literature suggest access to finance impacts on firms survival and growth (Story 1999 & Rahaman 2011)

• Characterised with poor financial and managerial knowledge – that negatively impacts on their start-up, survival and growth

• Challenges - market and institutional imperfections - adversely impact on innovative prospects of SMEs and negatively impact a country’s economic growth
Explanation for finance gap

• SMEs carry high risk of failure
• Lack financial information and knowledge
• Lack financial literacy
• consequently fail to provide financial information to evaluate the case for loan application
• therefore required to provide collateral
• Consequences:
  • Fail to:
    • make a start or operate at less than optimum level
    • Growth is restricted
    • Leads to societal loss
• Hence the case to examine the relationship between financial literacy, access to finance and firm growth
Financial literacy, finance & firm growth

- Financial literacy (FL) encompasses knowledge, cognitive skills, behaviour, attitudes which serve as enabling factors (Carrer and Klomp, 1996)
- FL is linked with innovation & economic growth (Audrechth et al, 2009; Carter and Jones-Evans 2006)
- Relationship between FL, access o finance and growth prospects are considered to be positive (Cooper, Gimeno-Gascon, and Woo 1994 and Rahaman, 2011)
- Firms with FL out perform others as owner/ managers can effectively make use of financial resources - giving them competitive advantage (Helfat et al. 2007)
- FL and management skills enables entrepreneurs to make strategic decisions to create and adopt technology and resources at large
Financial literacy, finance & firm growth

• Financial decisions fundamentally impact start-ups, established and growth orientated enterprises (Engelen et al. 2014)

• This paper supports this assertion FL is a predictor of firms’ success (Cole et al. 2009; Lusardi and Tufano, 2009 and Adomako et al. 2016).

• FL enables managers to:
  • make strategic & optimum investment decisions
  • perform external role – raise and manage finance
  • perform internal role – manage credit, budgets, debtor
Link between FL & access to finance

• Poor financial literacy & education adversely impacts on:
  • on access to external finance
  • information asymmetry- gives rise to diligence & monitoring cost
  • Higher rate of rejections from formal institutions
  • Poor utilisation of financial information for decision making

• Financial literacy provide enabling environment for SMEs, academics and practitioners’ to understanding linkage as they are under explored.

• Hence the case for this research is to examine impact of financial literacy on managers’ behaviour and conduct
Figure 1: Conceptual model

Relationship between financial literacy and firm growth

Elementary level literacy & numeracy

Elementary level financial literacy

Entrepreneurial literacy

Understanding - cluster of core financial concepts

General education

Daily operational level financial literacy

Production of financial information:
- Monthly
- Quarterly
- Yearly

Mitigates information asymmetry

Enhances access to finance

Assets accumulation & collateral

Firms’ growth
Relationship between financial literacy, access to finance and success of firm

- Owner/managers’ education, financial literacy, approaches to access & manage finance varies, consequently their impact on innovation, management and growth of firms varies
- Choice and preferences for finance, management style & desire for growth also vary with education, experience, gender and age
- However, relationship between:
  - educational level and access to external finance – well established
  - financial literacy and financial outcomes – well established
  - financial literacy and stock market participation – well established
  - financial literacy and financial innovations – not established
  - financial literacy and access to external finance – not established
Hypotheses:

- Whether financial literacy:
  - mitigates information asymmetry – reduces type I and II errors
  - moderates access to external finance
  - enhances productivity and growth of firms
  - optimise firms capital structure
  - is positively correlated with growth of firms
Research methodology

- Having considered complexities, range of SMEs and methodological approaches available, two stage study:
  - qualitative and then complement findings with
  - a larger quantitative study.

- Survey method:
  - A sample of 700 was identified from West Midland – Birmingham, Coventry, Wolverhampton; within approximately radius of 20 miles
  - In the phase 1 – (purposive sample) qualitative study, 41 interviews lasting 30-50 minutes
  - Contacts were made through a letter, phone calls, personal contacts and e-mails
  - Phase 2 – Quantitative study, currently work is in progress, 73 completed questionnaires (target 150+)
  - To achieve the target, 150 using snowball technique, relying on personal and organisational networks,
  - Location - why chose this area? Within West Midlands, SMEs are rapidly replacing large firms
  - Reporting findings from 41 interviews at this stage

- Challenges – access, reluctance of owner/ managers to participate
Findings

• Respondents reported:
  • 71% - Education is an important factor for innovation and growth
  • 89% - FL is an important factor for planning, innovation and growth
  • 71% - Lack of FL limits access to external finance
  • 79% - FL positively impacted on their attempt to raise external finance
  • 87% - FL had no impact on the cost of loan (financial information was only for internal banks’ risk assessment)
  • 75% - Felt FL did not mitigate the need for the collateral
  • 45% - Optimal capital structure & enhanced productivity
  • Reported a positive correlation between:
    ➢ access to finance & growth - 56%
    ➢ type of finance & growth - 51%
    ➢ Type, duration of finance & growth - 42%
    ➢ financial literacy and growth - 63%
  • 65% of respondents reported access to finance & start of enterprise positively impacted on family life.
  • 73% - Understanding / preparation of financial information helps to communicate with finance providers
Implications:

- This study suggests:
  - FL needs to be embedded in schools and Higher education syllabuses to support prospective entrepreneurs
  - Financial management education should be promoted amongst new and existing owner/manager to improve their management and decision making skills
  - Government should support FL initiatives to equip SMEs to improve efficiency and growth prospects
  - Improved FL would improve understanding amongst lender and entrepreneurs and mitigates information asymmetry
  - Financial literacy is trajectory for growth and it has to be an integral part of firms strategic management decisions
  - From an empirical and a theoretical perspective, this exploratory paper contributes to the development of the literature on financial literacy and demonstrates its impact on access to finance and firms’ growth
Thank you