Role of Financial Literacy in Developing Entrepreneurship and Innovation

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ABSTRACT

Research conducted throughout the globe inclines that financial literacy can play a significant role in entrepreneurial success. Financial literacy is understood as the ability to understand finance. More specifically, it refers to the set of skills and knowledge that allows an individual to make informed and effective decisions through their understanding of finances. Any business particularly a new start up business is like a stool with three legs. The three legs are: a good product, an ability to sell the product and get it to the customer who needs it and the ability to manage the money. Like any three – legged stool if any of three legs falls off, the stool falls over. Managing the money is not only about raising money but it is about managing finances inside a company. It is about understanding the minimum that one needs to take intelligent financial decisions for his venture. Thus, the relevance of financial skills to successful entrepreneurship cannot be underestimated. In a dynamic and uncertain business environment entrepreneurs are faced with many challenges that can be overcome by acquiring financial knowledge. It is against this backdrop the present study has been undertaken with the aim of assessing the need of financial literacy to stimulate entrepreneurship. It endeavors to highlight how financial knowledge can lead to better financial decisions making on the part of startups to ensure financial security and success of their enterprise.

Keywords: Creativity Entrepreneurship, Financial literacy, Innovation, Money Management.

1. Introduction

Entrepreneurship is regarded as a power for employment creation, innovation, economic growth, and igniting sound and sustainable communities. Njoroge (2013), states that entrepreneurialism is a very important component in economic growth as it is one of the main factors of production besides land, capital and labor. It involves identification of four striking functions namely coordination, arbitrage, innovation and risk management. Any business particularly a new start up business is like a stool with three legs. These three legs are: a good product, an ability to sell the product and get it to your customer who needs it and the ability to

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manage the money or the finances. Like any three – legged stool if any of three legs falls off, the stool falls over. Managing the finances in a business enterprise points towards a concept, which is the call for attention in today's business world, especially in the developing countries, that is the financial literacy of the business persons and the entrepreneurs. Entrepreneurs are the people who have the creativity to develop an idea, the buoyancy to take the risks, and the persistence to turn the idea into a successful venture. Financial literacy is understood as the ability to understand finance and can be understood as conceived by Mak and Braspenning (2012) as the ability, knowledge and confidence in matters related to budgeting, saving, borrowing and investing. More specifically, it refers to the set of skills and knowledge that allows an individual to make informed and effective decisions through their understanding of finances. It often entails the knowledge of properly making decisions pertaining to certain personal finance areas like real estate, insurance, investing, saving, tax planning and retirement and involves intimate knowledge of financial concepts like compound interest, financial planning, the mechanics of a credit card, advantageous savings methods, consumer rights, time value of money, etc. Thus, it can be concluded that the term financial literacy involves several different concepts: financial awareness and knowledge in terms of financial products, institutions and concepts; financial skills, such as the ability to calculate complex interest rate; and finally, general financial capability in terms of managing money and financial planning. However, when delineating about the financial literacy of entrepreneurs, the concept needs to be defined in an out of the ordinary way which is suitable in an entrepreneurial setting. Consequently, the financial literacy and capability of entrepreneurs would include the ability to distinguish between personal and business finances, to be a competent buyer of financial services – understanding financial products, their costs and risks, and selecting what is suitable for the business, to anticipate the business's future financial needs under alternative scenarios, to assess the risks to which the business is exposed and prepare appropriate responses, to understand the decision-making process of finance providers, and thus appreciate how the business can become creditworthy or investment-ready, to relate the business's financial needs to a country's regulatory and fiscal framework – to appreciate the notions of regulatory and tax efficiency , to exercise financial management, that is, to use financial information to analyse business performance and create policies and controls that optimise this. Financial illiteracy can lead to self-exclusion from the formal financial system. Those who are financially literate are not likely to be intimidated by the complexity of the financial system and therefore can result in people making inappropriate decisions. Entrepreneurs must be able to make complex financial decisions every day, in all areas of life – from personal, referring to retirement savings and household management, to business decisions, which involves more or less complicated business financial management. Lack or no financial literacy, as Niederauer (2010) cautioned, would lead to shut down of the business. Thus, a good financial foundation of the entrepreneurs is also a significant barometer of the success and growth of the enterprises in a competitive business environment.

1.2 Entrepreneurship and Financial Literacy

Entrepreneurship has gained global prominence in shaping economies. Micro enterprises contribute significantly in the economic development because these types of enterprises create a bridge between a margin of purchase ability of the greater number of the population and the affordability of the products made available to the consuming public. The micro entrepreneurs have significantly shaped the economic activity in the countryside. Although with woofing contribution to the economy, the micro entrepreneurs are still beset with the troubles of financial management and low financial skills leading to an adverse impact on the future of the business. The strategies employed to address this concern are incorporating entrepreneurship in the formal educational programs, intensive training on financial literacy in order to make individuals arrived at informed judgments on the use of money to become more informed consumers, producers and investors as rightly put by Mak and Braspenning (2012), the main outcome of financial literacy is gaining confidence in financial decisions as depicted in **Figure 1**. Through proper financial education, the entrepreneurs would realize the significance of financial literacy topics such as record keeping, budgeting, personal finance and savings and investment, since these are viewed to be more important skills a business person must possess. Record keeping is the source of important information vital to critical decision-making, and responsible for minimizing risks. This measure of financial literacy suggests the effective record systems considered to be critical in business operation since business owners cannot rely on their memory to summarize all transactions of the day. Savings is another component which serves as economic security and also for accumulation of wealth for an improved living standard. The financing skill, the third measure of financial literacy, is the ability to obtain capital from outside sources with minimal cost and payoff obligation. Budgeting, on the other hand, refers to the expenditure planning and cash flow analysis which is very important to the success of the business operation and processes. Entrepreneurs need financial literacy not only for raising money but for managing finances inside a company. Being business owners they need to take intelligent financial decisions for themselves, for their department, for their company depending where they are. Financial literacy helps making effective positive changes to their sense of doing business.

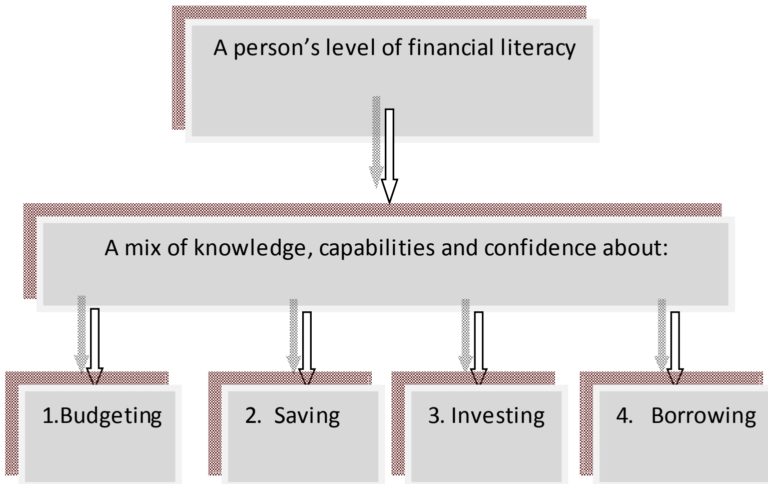

Figure 1: Picture of Financial Literacy

Source: Mak and Braspenning (2012)

Realizing the importance of financial literacy for the success and development of entrepreneurship efforts are being taken globally to improve the financial knowledge of entrepreneurs. However, as demonstrated in Table 1, internationally applied curricula overlap substantially and there is broad consensus that the financial capability of entrepreneurs should include an understanding of financial and risk management, record keeping and compliance, and of the main finance providers and their requirements.

Table 1: Examples of Widely used Financial Education Curricula Aimed at Entrepreneurs

'Money smart for small business' – US FDIC/SBA	**SME Toolkit – IFC/IBM**	**EFS/BDS model – USAID**
Organization types	Legal basics/incorporation	
Financial management	Financial management	Statements and forecasts
Record keeping	Bookkeeping and cash flow	Cash flow and financial systems
Banking services for SMEs	Finding financing providers' expectations	Funding options and
Credit reporting	Credit and collections	
Selling a small business	Buying a business	
Insurance and risk management	Insurance	
Tax planning and reporting	Regulations and policies	
Succession planning		
Time management		

Source: ACCA (2014)

Indian entrepreneurs like the rest of the world are faced with numerous challenges in running their small businesses. It is projected that majority of small medium enterprises do not continue to exist the first five years since establishment and three out of five new businesses fail within the first few months of operation. There are a lot of theories as to why so many new ventures fail. One such theory revolves around financial literacy. Inadequate business acumen, including poor financial literacy undermines entrepreneurial activity Bosma and Harding (2006). The cost of lack of financial literacy leads to financial indecisiveness, Lusardi (2009). Financial management is listed as one of the critical managerial competencies in new venture creation and development, Timmons and Spinelli (2007). Similar inferences were drawn by Drexler et. al (2013), who report that training to improve knowledge of finance and financial accounting indeed can have a positive effect on the management practices of small businesses in an emerging market. Indicatively, Bell and Lerman (2005) assert that a low financial management would lead to problematic cases like spending beyond regular means. In addition, Oseifuah (2010) conclude that entrepreneurs, regardless of their age, are routinely involved in decision-making activities concerning resource acquisition, allocation and utilization. Such activities almost always have financial consequences and thus, in order to be effective, entrepreneurs must be financially literate. Yet, previous results that can be found in the practice and the literature indicate that most of the entrepreneurs are not fully capable of making quality decisions in the field of financial management.

2. Research Problem

In a dynamic business environment entrepreneurs are faced with many challenges that can be overcome by acquiring financial knowledge. Ideally financial education would give an entrepreneur an upper hand in making financial or investment decisions when compared to a counterpart with no basic financial education. Entrepreneurs with training on business skills were found to perform better than their counterparts with no business management knowledge. Thus, the relevance of financial skills to successful entrepreneurship must be recognized and special attention should be provided on the part of government and other players in the institutional framework for financial literacy towards the financial knowledge of entrepreneurs to ensure survival of these business enterprises in today's highly sophisticated era of financial markets. Many studies have mainly delineated on importance of financial literacy and its effects on household or personal financial behavior with little theoretical and empirical study on the role of financial literacy in entrepreneurial success and innovation. This paper considers how financial literacy and capability relate to entrepreneurs. In this study, we deep further in an attempt to find out whether financial literacy has a positive effect on entrepreneurship and innovation by making a thorough review of literature on the subject. It attempts to ascertain does it matter whether one has basic financial awareness to run a business enterprise or not? Does a financially literate person possess a better chance in entrepreneurship than his financially ignorant counterpart?

How far enterprises run by financially literate people are better off than the ones operated by less financially aware individuals?

2.1 Rationale of the Study

Detection of factors that may affect the entrepreneurial success is an important issue for researchers and practitioners, especially in economies where lack of capital and institutional support impose severe restrictions on the entrepreneurship growth. Academic research on entrepreneurship have identified many factors which contribute to entrepreneurship and entrepreneurial success including attitude toward risk and optimism, access to capital, family background , peer effects, cognitive ability and so on. What about financial literacy? The present is an attempt to highlight how financial literacy plays an important role in developing entrepreneurship.

3. Objectives of the Study

The present study aims to achieve the following objectives:

1. To bring to light burgeoning importance of financial literacy in the growth and development of entrepreneurship and innovation.
2. To present comprehensive appraisal of studies on the significance of financial awareness of budding entrepreneurs to ensure the survival of their ventures.

3.1 Methodology

This study being a review paper mainly used secondary sources of data. Various research papers, reports of surveys, and articles delineating on relationship between financial literacy and entrepreneurship published across different countries have been studied thoroughly to achieve the objectives of the study.

4. Review of Literature

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. Several countries in the world are promoting financial education as a tool of fighting poverty (UN 2003), some of the countries involved are Egypt, Uganda, Ghana, South Africa, Tanzania, Kenya (African Development Bank, 2007). A compelling body of evidence demonstrates a strong association between financial literacy and entrepreneurs' success. They conclude that being financially aware enhances the overall quality of the entrepreneur by providing the basic numeric and financial literacy skills that increases the chance of survival. A good number of surveys conducted throughout the globe show that small and medium enterprises (SMEs) that are run by financial literate entrepreneurs have a higher chance of being more successful than their illiterate counterparts. Hogarth (2006) argues that financial literacy helps in developing a better understanding of the need to save, invest, insure, borrow from banks for productive purposes, provide for the future etc. Further, the author also asserts that the benefits of financial education would result in increasing the low participation and also availing new services. In addition, Mishra (2012) in his study contended that financial education is imperative to improve financial capability of Indian citizens. He suggested imparting financial education to different groups including kids, college students, teachers, parents and women. Research conducted throughout the globe inclines towards the fact that financial literacy among young entrepreneurs contributes meaningfully to their entrepreneurship skills. For example, Kotzè and Smit (2008) conclude that entrepreneurs wanting to start new ventures need to feel confident with their personal finances, as well as the finances of the new venture. They further assert that if individuals are illiterate concerning their personal finances, their financial management of new ventures will also be lacking and will lead to reduced new venture creation and possible failures of their ventures. In this regard, Bloom et al. (2010) also 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. Entrepreneurs' lack of financial capability is often portrayed as part of the reason for the substantial churn in the sector (New Vision 2011). Additionally, Nunoo and Andoh (2012) found that financial literacy is crucial in stimulating the business sectors. Financially literate Small and Medium Enterprises may save more, and better manage risk. The results of the study proved that financial literacy has a positive effect on SMEs' performance. Into the bargain, Mak and Braspenning (2012) while assessing the financial literacy in European Consumer Credit Law state that financial mistakes occur on a regular basis, and this seems partly due to the fact that consumers are not sufficiently knowledgeable, experienced, or confident to make sound financial decisions. The study reports that empirical evidence has shown that for debt-related decisions like consumer credit and mortgages, personal education via one-on-one counseling and the settlement of personal objectives, such as a targeted reduction of one's debt, lead to an improvement of consumer financial decision making OECD (2005). The authors further argue that financial mistakes resulting from a lack of financial literacy on the part of consumers and entrepreneurs can and should be anticipated and avoided through legal regulation and by imparting financial education. There is ever more evidence supporting the view that consumers lack financial literacy and that they, in result, are prone to bad decision making with regard to financial products. Also, Njoroge (2013), while trying to ascertain the link between financial literacy and entrepreneurial success concludes that there is a correlation between financial literacy and entrepreneurs' behavior. Entrepreneurs with financial education are better placed to make better financial decisions in investment and risk management. The study also found that small and medium enterprises that are more successful are run by entrepreneurs who are financial literate and understand key financial concepts that include risk management, interest rates, time value for money and financial markets. Further, the study asserts that there is a higher chance for financially literate entrepreneurs to be more successful than those with low level of financial knowledge. Additionally, Sucuahi (2013) indicated that due to the moderate level of financial literacy of the micro-entrepreneurs in Davao City, there was not a so impressive financial management of their resource. Into the bargain, Wise (2013) while trying to investigate the impact of financially literacy on new venture survival found that an increase in financial literacy led to more frequent production of financial statements, and the entrepreneurs who produced financial statements more frequently had a higher probability of loan repayment and a lower probability to close their venture involuntarily. On the same lines, Gupta and Kaur (2014) found that micro entrepreneurs who possess low awareness regarding different financial products and instruments revealed deficient record keeping practices, poor cash management and improper saving habits. These constraints are becoming a contributing factor in affecting their income as well as growth to some extent. The study showed that individuals who had acquired financial education have higher discount factors than those who have not attained. Pertinently, in one of the landmark survey, the World Bank's 2014 Global Financial Development Report (World Bank 2013) noted that small and medium-sized enterprises (SMEs), and particularly informal businesses or SMEs in emerging markets, face significant financing constraints that undermine their contribution to employment, productivity growth and innovation. It also noted, however, that financial sector practitioners saw financial education as the most effective means of addressing financial exclusion for households and businesses. In the same context, Lusardi Annamaria (2015) while confirming the importance of financial literacy for entrepreneurship concludes that financial literacy is a significant determinant of the likelihood of being an entrepreneur. The study also concludes that financial literacy is significantly associated with better financial outcomes. Highly financially literate entrepreneurs are found to be 24% less likely to be over-indebted, 20% less likely to be vulnerable to shocks and over 60% less likely to go bankrupt than their financially illiterate counterparts. All these perspectives call attention to the importance of financial literacy for promoting entrepreneurship and assert that lack of adequate financial knowledge of the budding entrepreneurs undermines the probability of their new venture success.

5. Conclusions

Based on the review of the extant literature on the understudy subject, the study concludes that financial literacy is an essential aspect in the development of entrepreneurship both in the developing and developed countries. The financially literate entrepreneurs are more likely to evaluate the available information well, to take right decisions about financial matters, to depict a responsible financial behaviour by being able to protect themselves from the mistake of following the herd parable and to conduct the financial management of their unit efficiently and effectively. The empirical research has revealed a direct impact of increased financial literacy on better performance of the business enterprises. The business owners who are confident in financial matters display more calm and mindful tactics in dealing with the various business matters of their units. The business units run by financially knowledgeable individuals outperform the ones handled by the ones who are less aware in financial matters. The survival rate of Small and Medium Enterprises (SMEs) owned by financially aware entrepreneurs is much encouraging and promising than their counterparts controlled by financially illiterate people. SMEs that are more successful are run by entrepreneurs who are financial literate and understand key financial concepts that include, risk management, interest rates, time value for money and financial markets. Financial literacy exposes entrepreneurs to better decision making skills about borrowings, risk taking, diversifications, and investments. Financial capability of entrepreneurs ensures sound financial management of their business units, which in turn lead to the financial security and overall development of the venture.

6. Suggestions

On the basis of the conclusions of the study, the following suggestions are proposed to the concerned stakeholders under the National Strategy for Financial Education:

- The study suggests that financial institutions should educate Small and Medium Enterprises (SMEs) in informal sector the basic financial concepts in order to boost their risk profile. Financial institutions can play a very important role in financial literacy due their frequent interactions with SMEs in financial matters.
- Instead of thinking that every business needs a loan and the idea that financial education should be about knowing how to choose external finance, the concerned parties should first and foremost think about financial management of the likely venture so that the business can be financing itself to the extent possible and be more creditworthy and confident.
- Special attention should be paid towards financial awareness of the potential entrepreneurs so that better planning is carried out, thus, when the business does seek external finance, it is the right kind of finance, at the right time and for the right reasons.
- The youth who possess adequate level of awareness about concepts like risk management, interest rates, time value of money, financial markets, diversification, investment, tax, leverage, financial risk, and market confidence etc. should be more encouraged to take up entrepreneurship to ensure the survival of the future ventures than the others who lack financial awareness.

7. Limitations of the Study

The main limitation of the study is that it used the secondary data available on the subject to achieve the understudy objectives, which poses limitations on the broader generalizations of the conclusions.

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