

## The Financial Literacy of Micro Entrepreneurs in South Africa

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**ABSTRACT** The research investigated the level of financial literacy of the owners of new micro-enterprises in South Africa. This study used financial planning, analysis and control, book-keeping, understanding of funding sources, business terminology, finance and information skills, use of technology and risk-management to measure the financial literacy of entrepreneurs. Data was gathered through the use self-administered questionnaire in a survey. A combination of dichotomous and Likert scale questions were used for the survey. Descriptive statistics was used for data analysis. The results suggest a low level of financial literacy by the owners of new micro-enterprises. Recommendations to improve financial literacy are suggested.

### INTRODUCTION

South Africa suffers from a high level of unemployment with an official estimate of approximately 25.2% of the economically active population unemployed (Statistics South Africa 2014). In addition, the country experiences high levels of poverty and income inequality. Micro-enterprises (a part of the broad small medium and micro enterprises sector (SMMEs) are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development in South Africa (FinMark Trust 2006). According to Rolfe et al. (2010), micro-enterprises are the most pervasive entrepreneurial activity in South Africa. 70% of the micro-enterprises are in the retail and commerce sectors. Samujh (2011) points out that despite the importance of micro enterprises, they tend to be overlooked, intentionally or unintentionally in small business research.

In addition, new SMMEs are critical to South African economy. According to Maas and Herington (2006) new SMMEs are seen as a significant component of the solution to South Africa's development issues. The creation and sustainability of new SMMEs are vital to the economic prosperity of South Africa. Despite the highlighted contributions of micro enterprises in South Africa, these enterprises suffer from a high failure rate. Van Scheers (2010) points out that the failure rate of small groceries shops (mainly micro enterprises) in South Africa points is between 70% and 80%. Adcorp (2012) reveals that around 440,000 micro and small enterprises

(including those in the retail sector) have closed in the last five years in South Africa.

Freiling and Laudien (2013) argue that deficiencies in skill significantly contribute to the failure of new businesses. According to Naqvi (2011), failure factors of SMMEs include poor business and financial management competencies. Drexler et al. (2010) point out that both individuals and entrepreneurs are asked to make difficult financial decisions in many aspects of life, whether in their personal finances or as business owners. Cole and Fernando (2008) assert that there is a strong association between financial literacy, the ability to make good financial decisions and household well-being and business survival. A review of the literature on financial literacy in South Africa such as Kotze and Smit (2008) and Oseifuah (2010) revealed that no study has empirically investigated the financial literacy of the owners of new micro enterprises in South Africa.

### Objective of the Study

The failure rate of new SMMEs is very high in South Africa. Sound financial management is crucial to the survival and well-being of small enterprises of all types. Financial literacy is critical to sound financial decisions (personal and business) by new entrepreneurs. The objective of the study is to measure the level of financial literacy of the owners of new micro enterprises.

### Literature Review

Huston (2010) points out that there is no universally accepted definition of financial liter-

acy. Authors have proposed several definitions. Huston (2010) describes financial literacy as measuring how well an individual can understand and use personal finance-related information. In addition, financial literacy includes the ability and confidence of an individual to use his/her financial knowledge to make financial decisions. The Organisation for Economic Cooperation and Development (2005) defines financial education leading to financial literacy as: “*the process by which financial consumers/investors improve their understanding of financial products and concepts and, through information, instruction, and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being.*” The United States Financial Literacy and Education Commission (2007) describes financial literacy as “*the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being.*” ANZ (2008) defines financial literacy as “*the ability to make informed judgments and to take effective decisions regarding the use and management of money.*” ANZ (2011) asserts that financial literacy consists of five separate components. These are keeping track of finances, planning ahead, choosing financial products, staying informed, and financial control. Most of these definitions relate to personal financial literacy.

In the context of a small business, the Banking Association of South Africa (n.d) defines a financially-literate SME as one “*which: (i) has an adequate level of personal entrepreneurial competencies, personal finance skills, and business management skills; has an appropriate level of understanding of functional financial management systems; (ii) has an appropriate level of understanding of SME life-cycle funding and other financial services needs and options and knows where and how to source and negotiate those funding and service requirements; (iii) understands and can manage financial risks or seek relevant advice to manage such risks; (iv) understands legal, regulatory and tax issues as they relate to financial matters; (v) understands the range of legal recourses it can resort to when necessary, and*

*namely, in case of bankruptcy or other situations of financial distress.*”

The United States Agency for International Development (2009) defines a financially literate SME owner/manager as “*someone who knows what are the most suitable financing and financial management options for his/her business at the 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.*” Financial literacy is important to an individual in his/her personal as well as his/her business capacity. Consumer financial literacy focuses on the individual and his/her ability to manage personal financial decisions. SME financial literacy focuses on an individual’s ability to translate financial literacy concepts to business needs.

Lusardi and Mitchell (2013) point out that theoretical models link financial literacy to consumer behaviour especially the aspects of savings and consumption. The theoretical models assume that people are able to formulate and execute saving and consumption plans and these require expertise in dealing with the financial markets, knowledge of purchasing power, and the capacity to undertake complex economic calculations. Thus consumer behaviour and it link to financial literacy can be linked to the works of Modigliani and Brumberg (1954) and Friedman (1957). According to Modigliani and Brumberg (1954), individual receives utility only from present and prospective consumption. The rate of consumption in any given period is a facet of a plan which extends over the balance of the individual’s life, while the income accruing within the same period is but one element which contributes to the shaping of such a plan. Friedman (1957) suggests that the total amount spent on consumption is on the average the same fraction of permanent income, regardless of the size of permanent income. The magnitude of the fraction depends on variables such as interest rate, degree of uncertainty relating to occupation, ratio of wealth to income, family size. This suggests that financial literacy can be used to consumer and business behaviour.

Miller et al. (2009) and Glaser and Walther (2013) ascertain that financial literacy is important for several reasons. Financial literacy can

help to prepare consumers (and businesses) for tough financial times, by promoting strategies that mitigate risk such as accumulating savings, diversifying assets, and purchasing insurance. Financial literacy also helps to improve behaviour such as the avoidance of over-indebtedness. Financial literacy enables people (individuals and business owners) to make better financial decisions and to understand and manage risk. Financially literate consumers and business owners help to reinforce competitive pressures on financial institutions to offer more appropriately priced and transparent services.

Financial literacy is needed for effective money management. Bruhn and Zia (2011) investigated the impact of business and financial literacy program on firm outcomes of young entrepreneurs. The results indicate that entrepreneurs with higher levels of financial literacy show better business performance and sales. Andoh and Nunoo (2011) find that the financial literacy of owners of SMEs is a very important factor in explaining utilization of financial services by SMEs. Low levels of financial literacy can prevent SMEs from understanding and assessing financial products from financial institutions. The Association of Chartered Certified Accountants (2014) points out that one of the challenges facing financial institutions is the generally low level of financial awareness among small business owners. Wise (2013) finds that increases in financial literacy leads to more frequent production of financial statements. An entrepreneur that produces financial statements more frequently has a higher probability of loan repayment and a lower probability to voluntarily close his/her business. According to Kotzè and Smit (2008), lack of personal financial literacy impacts negatively on the financial management of new ventures and can lead to possible failures of SMEs. Sucuahi (2013) points out that the significant role of the micro enterprises can be well-harnessed and sustained through a fine and precise financial management of the entrepreneurs themselves. A good financial foundation of the entrepreneurs is a significant barometer of the success and growth of the enterprises.

In addition, financial literacy impacts on access and payment of loans. In South Africa, one of the causes of the high failure rate of new micro enterprises is the non-availability of formal sector financing. According to Herrington et al. (2009), access to finance is a major problem for

the South African entrepreneur. A good level of financial literacy can improve access to finance by new ventures (Wise 2013), reduce the chance of loan default (Kotzè and Smit 2008) and improve sales and business performance (Bruhn and Zia 2011).

## RESEARCH METHODOLOGY

The survey was conducted in Johannesburg Central Business District, Gauteng province of South Africa. The empirical approach consists of data collection through the use of self-administered questionnaire in a survey. According to the Parliament of the Republic of South Africa (1995), a micro-enterprise is a business with (1) total full-time equivalent of paid employee of less than 5 (2) total annual turnover of less than R150,000 and (3) total gross asset value (fixed property excluded) of less than R100,000. Maas and Herrington (2006) observe that the creation of a new small firm is a two-stage process. The first phase is the start-up phase, a three month period during which individuals identify the products or services that the firm will trade in, access resources and put in place the necessary infrastructure such as staff. The next phase, a period of 3-42 months, is when the small firm begins to trade and compete with other firms in the market place. Therefore, a new micro-enterprise can be described as a business that has been in existence for a period not longer than forty-two months. Once a firm has successfully existed for more than 42 months, it becomes an established firm. The focus of the study is on new micro-enterprises in the retail sector. These are enterprises that have been in existence for 42 months or less and employ less than five employees. Because of the difficulty in obtaining the population of micro-enterprises in the study area, convenience sampling and the snowball sampling methods were used. The use of convenience sampling is consistent with previous empirical studies on micro and small enterprises in South Africa such as Arko-Achemfuor (2012). A pilot study was conducted on the survey instrument used in this research with ten owners of new micro-enterprises in the retail sector in order to ensure face and content validity. Owners were assured of confidentiality with regard to the data collected. The questionnaires were given to the owners of the micro-enterprises to complete. Descriptive statistics was used for data analysis.

### Measuring Financial Literacy

There is no standardised measure of financial literacy (Cole and Fernando 2008). According to the Banking Association of South Africa (n.d), measuring financial literacy for an entrepreneur should include an understanding of consumer and personal finance, accounting and financial management systems, financial products and service options, financial risk, capital investment and legal and tax issues. The United States Agency for International Development (2009) used finance related knowledge, (awareness of sources of finance, awareness of business finance technology and consumer financial literacy), finance related business skills and information skills to measure financial literacy for an entrepreneur. Oseifuah (2010) and Wise (2013) used mathematical and computer literacy, financial attitude, financial knowledge and financial behaviour to measure financial literacy. Sucuahi (2013) used record-keeping, budgeting savings, financial skills to measure financial literacy. This study used the following concepts to measure the financial literacy of new micro entrepreneurs. (1) Financial planning, analysis and control (2) Book-keeping (3) understanding of funding sources (5) Business terminology (5) finance and information skills (6) use to technology and (7) risk-management (insurance).

### RESULTS AND DISCUSSION

Seventy-six questionnaires were distributed to new micro enterprises in the retail sector and thirty four questionnaires were returned. The response rate was 44.7%. Thirty- three respondents were sole proprietors and one was a partnership. Twenty- four respondents were males and ten respondents were females. Three respondents have no employee, eleven respondents

have one employee, sixteen respondents have two employees, two respondents have three employees and two respondents have four employees. Nineteen respondents have Matric qualification and fifteen respondents have post-Matric qualification.

### Financial Planning, Budgeting and Control

The results as depicted by Table 1 indicate that most of the micro enterprises' owners do not engage in formal financial planning, budgeting and control. Berry (2011) points out that financial planning and control systems should be used by micro enterprises. There is a positive relationship between having a formal financial control and control system and business success. In addition, budgeting is an aid to better management of an enterprise and to achieve higher profits or minimise losses. However, it has to be understood that most micro enterprises are survivalist and informal. Micro enterprises might have some form of budgeting and financial planning and control but on an informal basis. The results are consistent with the findings of Abanis et al. (2013) that most small businesses do not engage in formal financial planning, budgeting and control. Warue and Wanjira (2013) find that lack of budgeting is one of the causes of failure for small business. Uwonda et al. (2013) find that failures in many SMEs can be linked to inadequate cash flow management. The majority of SMEs do not prepare cash budgets.

### Book-keeping

The results as indicated by Table 2 show that apart from sales book and expenses books, most micro-enterprises do not keep other books that will allow them to extract useful accounting

**Table1: Financial planning, budgeting and control by the respondents**

	<i>Never</i>	<i>Rarely</i>	<i>Sometimes</i>	<i>Often</i>	<i>Always</i>
<i>Financial Planning</i>					
Do you have a written financial objectives of what you want to achieve in a year or your business	34	0	0	0	0
<i>Budgeting</i>					
Do you prepare a written budget of income and expenditure	29		4	0	1
<i>Control</i>					
Do you compare your financial objective to your performance	34	0	0	0	0



information. In addition, the results indicate that most micro-enterprises still use manual methods instead of computers for operations. The results are consistent with the findings of Agyei-Mensah (2011) and Maseko and Manyani (2011) that the majority of small firms do not keep complete accounting records because of lack of accounting knowledge. As a result there is inefficient use of accounting information in financial performance measurement. Access to finance by small businesses depends largely on their quality of accounting information. Quality accounting information will enhance financial management as well as accessibility of finance by small businesses. Amoako (2013) find that SMEs do not maintain proper books of accounts because owners do not appreciate the need to keep accounting records. Thus, the application of accounting information to support assessment of financial performance by SMEs is not efficient.

**Table 2: Book-keeping by the respondents**

<i>Do you keep the following accounting books</i>	<i>Yes</i>	<i>No</i>
Sales book	19	15
Purchase book	13	21
Expenses book	19	15
Fixed assets register	33	1
Stock book	16	18
Cash book	16	18
Debtors book	15	19
Creditors book	16	18
Do you have computers to record your transactions	2	32

### Funding Sources

The results as depicted by Table 3 indicate that most of the respondents have bank accounts but most do not have business accounts. The lack of business account may impact negatively on the availability of bank loans to immigrant entrepreneurs. The majority of the respondents do not bank their takings on a daily basis. This may negatively impact on access to loans by immigrant entrepreneurs as commercial banks will not have an accurate assessment of their businesses. Most of the respondents do not invest the balance in their accounts. Investments even for a short-term period can add value to a business. Abanis et al. (2013) find that only a few SMEs that have cash surplus, do invest in marketable securities in order to generate more

**Table 3: Understanding of funding sources by the respondents**

	<i>Yes</i>	<i>No</i>
Do you have a personal bank account	33	1
Do you have a business account	16	18
Do you bank your takings on a daily basis?	11	23
Do you invest the cash balance in your account?	1	33
<i>If You Need Finance For Your Business, Are You Aware Of Where You Can Get Finance</i>		
Commercial banks	34	0
Micro finance	32	2
Stokvel	33	1
Business angels	2	32
Venture capitalist	2	32
Are you aware of the requirements of commercial banks in lending money to businesses	8	26
Have you ever checked the websites of commercial banks for you to see the credit products and their requirements	3	31
Have you ever prepared a business plan	2	32
Are you aware of some government agencies that can provide financial and non-financial assistance to you (SEFA, SEDA)	14	20

income. This practice hinders their growth and eventually leads to their failure. Most of the respondents know that if they need credit, they can approach commercial banks, micro finance and stokvel. Most of them are not aware of business angels and venture capitalists. The results indicate that the awareness of government agencies that provide financial and non-financial assistance to SMMEs is limited. This can further perpetuate inaccessibility to external finance by micro enterprises. According to Demircuc-Kunt et al. (2006), the two primary sources of external finance for SMMEs are equity and debt. External equity in the form of venture capital or the stock exchange is usually not available for SMMEs. Entrepreneurs must thus primarily rely on debt when raising external funds. Blumberg and Letterie (2008) agree that the lack of venture capital funds makes many new SMEs dependent on bank loans, overdrafts and suppliers credit for early-stage financing.

### Understanding of Business Terminology

The results as depicted by Table 4 reveal that most of the respondents understand basic

business and financial terminology such as saving, loan, investment, collateral, insurance and interest rate. However, more sophisticated technologies such as asset-based lending, debtor finance are not understood by the respondents. In addition, most of the respondents do not know the current repo rate, tax rate and inflation rate. The interest rate affects the cost of funds (Britzelmaier et al. 2013; Abanis et al. 2013). Failure to understand the interest rate may negatively impact on the ability of micro entrepreneurs to make effective savings and investment decisions.

**Table 4: Understanding of business terminology by the respondents**

<i>Understanding of Business Terminology</i>	<i>Yes</i>	<i>No</i>
Saving	34	0
Loan	34	0
Investment	32	2
Collateral	34	0
Taxes	34	0
Insurance	34	0
Interest rate	34	0
Credit card	34	0
Hire purchase	34	0
Stock market	31	3
Asset-based lending	1	33
Debtor finance	1	33
Business plan	31	3
<i>Understanding Rates (Current Rates)</i>		
Repo rate	6	28
Tax rate	8	26
Inflation rate	3	31
Exchange rate	2	33

## Finance and Information Related Skills

### Finance and Information Related Skills and Use of Technology

The respondents were asked to rate themselves on their finance and information related skills on a five point Likert scale ranging from “1 very poor to 5 very good”. The results as shown in Table 5 indicate that on the average micro entrepreneurs are weak in finance and informa-

**Table 5: Finance and information related skills of the respondents**

	<i>Mean</i>	<i>Standard deviation</i>
Accounting and book-keeping	2.26	0.94
Business plan preparation	2.02	0.89
Computer literacy	2.18	0.97
Internet usage	2.03	0.91

tion related skills. Padachi (2010) finds that SMEs do not attach importance to accounting and finance function. The absence of formal accounting systems in SMEs may be due to lack of financial and accounting knowledge among the owner manager. Mitchelmore and Rowley (2013) find that financial competencies have an impact on firm performance and growth. Pretorius and Shaw (2004:225) note that a good business plan is needed to obtain credit from financial institutions.

In addition, the results as shown by Table 6 indicate limited use of technology. Most of the respondents do not have Email addresses, access to the internet at work. None of the respondents has a webpage. Information technology can help to access information that can improve financial literacy. Kharuddin et al. (2010) find that information systems improve the efficiency and performance of SMEs.

**Table 6: Use of technology by the respondents**

	<i>Yes</i>	<i>no</i>
Do you have an e-mail address	8	26
Do you have access to the internet at work	2	32
Do you have a web page	0	34

## Risk Management (Insurance)

The results as indicated by Table 7 show that most of the respondents do not have insurance policy covers for their business with a view of reducing their risk. Iopev and Kwanum (2012) point out that risk management is particularly vital to the survival for small businesses. However, the majority of SMEs do not have insurance to cover their business against risk.

**Table 7: The use of insurance by the respondents**

	<i>Yes</i>	<i>No</i>
Business insurance	2	32

## CONCLUSION

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 is to measure the level of financial literacy of the

owners of new micro enterprises. This study used financial planning, analysis and control, book-keeping, understanding of funding sources, business terminology, finance and information skills, access to technology and risk-management to measure the financial literacy of entrepreneurs. The results indicated that most of the micro enterprises' owners do not engage in formal financial planning, budgeting and control and only keep some books of account. Most of the respondents understand commercial banks as a source of finance but do not understand the sources of equity finance and the requirements to obtain a loan. There is an understanding of simple business terminology, however, the understanding of current interest, tax and exchange rates seem to be deficient. There are major weaknesses in finance and information related skills, use of technology and risk management. The results suggest a low level of financial literacy by the owners of new micro enterprises.

### RECOMMENDATIONS

The curriculum in high schools and universities should include financial literacy so that potential entrepreneurs can understand financial literacy early in life. Owners of micro-enterprises need to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards entrepreneurship and training. They can attend training programs organised by universities on financial management for non-financial managers and training programs organised by government agencies such as the Small Enterprise Development Agency (SEDA). In addition, since micro-enterprises are the most dominant business in South Africa, organisations responsible for SMMEs in South Africa such as SEDA should have well trained field agents to visit and train micro-enterprises on a regular basis on how to improve their financial literacy. These organisations should organise training on financial literacy for SMMEs.

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