



African Journal of Commercial Studies

Publisher's Home Page: <https://ijcsacademia.com/>



Review Paper

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Effect Of Financial Literacy on The Growth of Micro and Small Enterprises in Kenya

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Article Info

Volume 4, Issue 1, January 2024

Accepted : 21 December 2023

Published : 31 December 2023

doi: [10.59413/ajocs/v4.i1.3](https://doi.org/10.59413/ajocs/v4.i1.3)

Ark: ark:/69431/AJoCS.v4i1.3

Abstract

Micro and small enterprises (MSEs) constitute a vital segment driving economic growth and employment opportunities in various economies, especially in developing nations like Kenya. This study aims to comprehensively explore the intricate relationship between financial literacy and the growth trajectory of MSEs, in Kenya which is a developing country. The primary objective is to understand how proficiency in budgetary control, meticulous bookkeeping, adept debt management, and comprehensive knowledge of banking services influence the growth path of MSEs. The study integrates theoretical frameworks, including enterprise growth theories by Larry Greiner and the resource-based view theory advocated by Edith Penrose. Empirical findings reveal that MSEs, pivotal for economic impact, confront hurdles in accessing financial resources, often resorting to informal lenders with limited support and high interest rates. Insufficient knowledge about banking services, bookkeeping, and budgeting further hinders their growth. This research underscores the vital contribution of MSEs to Kenya's economy and the challenges impeding their growth. Emphasizing financial literacy as a key factor, the study provides theoretical foundations and practical insights.

Keywords: Financial Literacy, Micro and Small Enterprises, Economic growth

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1. Introduction

Small businesses are widely acknowledged by economies around the world as being crucial drivers of equitable development and overall economic growth. Numerous research studies have been conducted to explore the impact of micro and small enterprises (MSEs) on employment opportunities in developing countries, and the findings

consistently demonstrate that these enterprises play a significant role in this regard. In fact, it has been revealed that MSEs contribute to more than half of the employment opportunities in many developing nations. Mills and McCarthy (2014) have conducted extensive research in this area, and their estimations indicate that MSEs account for 50% of both formal and informal job opportunities within

the private sector. This highlights the substantial contribution of MSEs to the overall employment landscape in these countries. Furthermore, the estimates provided by the United Nations Industrial Development Organization (UNIDO) reveal that micro and small enterprises also make a substantial contribution to the gross domestic product (GDP) of many African countries, accounting for over 50% of the GDP. This underscores the significant economic impact of MSEs in Africa. Therefore, it is evident that MSEs are integral to the socio-economic fabric of developing nations, playing a pivotal role in generating employment opportunities and contributing to overall economic growth.

In the Republic of Kenya, there exists a unanimous agreement among a cohort of distinguished experts that micro and small enterprises (MSEs) indisputably assume the paramount role in the flourishing development of the nation's economy. The profound analysis conducted by the Kenya Institute for Public Policy Research and Analysis (KIPPRA) in 2016 incontrovertibly demonstrates that MSEs encompass a staggering proportion of over 90% of the entire labor force, thereby unequivocally substantiating their monumental contribution towards the commendable empowerment of the populace and the remarkable amelioration of the prevailing poverty levels within the nation's borders. It is worth noting that the inherent smallness of these MSEs has engendered a conducive environment that is conducive to the cultivation of groundbreaking innovation and the fostering of the entrepreneurial acumen that is pivotal in propelling the nation's economic trajectory towards unprecedented heights. Furthermore, the aforementioned report posits that these MSEs, despite their ostensibly diminutive size, exhibit a prodigious capacity to successfully employ and effectively manage an estimated 14.9 million diligent individuals across a wide array of diverse economic sectors that traverse the vast expanse of the Kenyan landscape.

A significant and resilient sector comprising micro and small enterprises holds the capability to propel the economy of Kenya by generating employment opportunities for its citizens while simultaneously facilitating production and consequently augmenting the country's potential for exports. In order for a developing nation like Kenya to achieve continuous and enduring economic advancement, it becomes imperative to establish and foster a thriving sector consisting of micro and small enterprises, which is further bolstered by apt policies and substantial investments. MSEs have been documented to exhibit a notable propensity for establishment; however, they are also prone to endure a truncated lifespan, as the majority fail to reach the three-year mark of operation. This phenomenon can largely be attributed to the inherent tendency for most MSEs to remain diminutive in scale, thereby rendering them exceptionally vulnerable to perturbations arising from the external milieu.

Evidentiary data has unequivocally demonstrated that the

expansionary trajectory of a business is not solely contingent upon the availability of financial capital and the existence of a propitious environment but rather hinges upon the expansive purview of financial management acumen that managers possess. Managers who possess a robust grounding in financial *modus operandi* tend to wield decision-making powers that are both judicious and essential for the sustainable growth of the business enterprise. The primary objective of this study is to comprehensively comprehend the extent to which an individual's acumen in the realms of budgetary control, meticulous bookkeeping, adept debt management, and comprehensive knowledge of the multifarious banking services available in the economic landscape can exert a profound influence on the growth trajectory of a business enterprise.

In summary, small and micro enterprises (MSEs) are recognized globally as pivotal drivers of equitable development and economic growth. Research consistently shows that MSEs contribute significantly to employment opportunities, with estimates indicating they account for over half of the job market in many developing nations. In Kenya, MSEs play a paramount role in the country's economic development, comprising over 90% of the labor force and contributing substantially to poverty alleviation. Despite their small size, these enterprises foster innovation and entrepreneurial acumen, making them crucial contributors to Kenya's economic trajectory. However, MSEs face challenges, including a propensity for short lifespans, often attributed to their vulnerability to external perturbations.

Recognizing the potential of MSEs to propel economic advancement, Kenya needs to establish and support a thriving sector through appropriate policies and investments. The study underscores the importance of financial management acumen, emphasizing that the expansionary trajectory of businesses relies not only on financial capital but also on managers' proficiency in budgetary control, bookkeeping, debt management, and knowledge of banking services. The primary objective is to comprehensively understand how individual acumen in these financial realms influences the growth trajectory of MSEs. This research contributes valuable insights into fostering a conducive environment for sustained MSE growth, ultimately contributing to Kenya's overall economic development.

2. Problem Statement

Available evidence from Asian economies reveals that it is primarily the micro and small enterprises (MSEs) that are actively pursuing growth and are therefore more inclined to adopt and implement technology and training programs. The integration of these technological advancements and skill development initiatives subsequently enables these MSEs to gain access to specialized markets, thus broadening their opportunities for expansion and success. In the

context of Kenya, a unique scenario unfolds within the MSEs sector, wherein there exists a distinct division comprising modern, capital-intensive businesses on one extreme end, juxtaposed with an informal sector on the other. This dichotomy results in a notably slender middle sector, as a significant proportion of MSEs succumb to premature demise before they can undergo a successful transition, while others continue to operate at a small scale without experiencing any substantial growth. An analysis conducted by KIPPRA (2016) illuminates the numerous challenges that confront MSEs in Kenya, including but not limited to difficulties in accessing timely credit, ineffective marketing strategies, and a dearth of skilled personnel.

Despite the implementation of various government interventions, the prevailing situation within the MSE sector remains largely unchanged. Previous research endeavors undertaken in this field often suffer from superficiality, as they fail to address the specific and intricate issues that plague the sector. Hence, the overarching objective of this present research study is to comprehensively comprehend the intricate interplay between financial literacy and the growth trajectory of MSEs in Kenya. In order to achieve this objective, the research centered on four key themes pertaining to financial literacy, which were explored in great depth and detail.

3. Theoretical Framework

3.1. Enterprise growth theories

In his 1972 work, Larry Greiner posits that enterprises progress through a series of five distinct stages of growth. These stages, according to Greiner, are creation, direction, delegation, coordination, and collaboration. The first stage, creation, encompasses a multitude of activities, such as the establishment of the business itself, the development of products and services, the dedication of extensive working hours, and the provision of modest salaries. Following creation is the direction phase, which is characterized by sustained growth and effective management practices. As the enterprise continues to expand, it enters the delegation phase, wherein a more decentralized structure is adopted and a considerable amount of responsibility is entrusted to lower-ranking managers and other employees. In the coordination stage, the establishment of a central headquarters becomes imperative in order to facilitate a smooth and clear flow of authority. Finally, the collaboration phase represents the pinnacle of growth, as interpersonal relations are enhanced and individuals actively support teamwork. Greiner further contends that each stage of growth experiences a relatively tranquil period of evolution, which eventually gives way to a management crisis, or revolution. Consequently, it is crucial to manage each stage differently in order to ensure a seamless transition and maximize growth potential.

3.2. Resource based view theory

The resource-based view (RBV) argues that a firm's

sustained competitive advantage is based on its valuable, rare, inimitable, and non-substitutable resources (Lockett & Thompson, 2001). In order for an enterprise to establish a competitive edge in comparison to other businesses, it is imperative that it possess specific resources both internally and externally. According to the insights provided by Edith Penrose (1959), the growth of an enterprise is contingent upon the possession of motivational knowledge and entrepreneurial skills. Furthermore, Penrose highlights the fact that the sustained growth of an enterprise hinges upon the extent to which the organization is prepared to harness new talent and integrate it into the existing management framework.

In order to ensure long-term growth, it is crucial for the management of an enterprise to distribute decision-making authority by cultivating an organizational culture that offers guidance to its employees. This perspective underscores the notion that for an enterprise to expand, the entrepreneur must possess the requisite knowledge to make informed and judicious decisions. Moreover, the introduction of fresh talent through training initiatives and the hiring of well-informed individuals will prove instrumental in seizing emerging opportunities that will ultimately facilitate the growth of the enterprise.

4. Empirical Review

In order for medium and small enterprises to achieve success and expansion to the extent that they have a significant impact on the overall economy, it is imperative that they have access to financial resources. However, the accessibility of these finances is somewhat limited due to the perception that these enterprises carry a higher level of risk, mainly because their future outcomes are uncertain. As a result, the majority of these enterprises are forced to rely on informal lenders, such as unregulated lenders, as well as family and friends, for their financial needs. Unfortunately, this heavy reliance on informal lenders has a negative effect on the growth of these enterprises, as the amount of finance that is available to them is inherently limited. Furthermore, the fact that they are dealing with unregulated lenders exposes them to high interest rates, which ultimately hampers the profitability of their business endeavors. Additionally, the lack of information regarding the various banking services that are available poses a significant hindrance to the growth of these enterprises. This lack of information stems from their inability to select a banking product that aligns perfectly with their specific business needs and requirements. According to Yavuzaslan et al. (2023), the culture we inherit and learn from our parents, teachers, and elders affects the way we behave in general and in business in particular. Therefore, financial literacy is essential to improving the success of small and medium-sized businesses.

The concept of bookkeeping can be defined as the art of maintaining detailed records of all monetary transactions

that occur within a business, with the ultimate goal of determining and understanding its financial position. Regardless of the size of the business, the practice of keeping written records is essential. According to [Frank Wood \(2010\)](#), the absence of financial records within a business can be likened to that of a blind person without the aid of a guiding tool. Wood emphasizes that financial records play a crucial role in enabling an enterprise to accurately calculate its profits and closely monitor the performance of its various products in the market. Furthermore, these records facilitate the tracking of the enterprise's assets and liabilities. In addition to their significance in the budgeting process, these records can also be presented to lending institutions when seeking financial assistance. However, the absence of the necessary knowledge and expertise in bookkeeping and accounting will undoubtedly impede the enterprise from reaping the aforementioned benefits. Consequently, this lack of knowledge will have a negative impact on the growth of the enterprise as a whole.

A budget can be defined as a comprehensive financial plan that outlines the anticipated activities and expenditures of a business in the future. It serves as a valuable tool for evaluating the performance of the business and its overall progress. The process of creating a budget can be described as budgeting, which encompasses the preparation, compilation, and ongoing monitoring of the budget. As [Nugus \(2006\)](#) suggests, a budget is indispensable as it enables a business to establish performance targets and effectively manage the available resources. However, the absence of the necessary knowledge and expertise in budgeting can result in the creation of less effective budgets that fail to adequately monitor business activities and ultimately limit the profitability and growth of the business.

Governments worldwide have demonstrated significant interest in the sector of medium and small enterprises, primarily due to its immense potential to drive economic growth and generate employment opportunities. However, despite this great potential, the sector faces numerous challenges that hinder its growth and development. [Muthiah and Venkatesh \(2012\)](#) imply that institutional barriers, such as legal requirements and financial constraints, have a detrimental effect on the growth of medium and small enterprises.

The majority of scholars who have explored the relevant literature on the subject agree that financial literacy plays a pivotal role in the growth of medium and small enterprises. While there are several determinants of growth, the financial skills possessed by the entrepreneur emerge as the primary driver of enterprise growth.

[Penrose \(1959\)](#) and [Gainer \(1972\)](#) are in agreement that the success of an enterprise is heavily reliant on the owner's ability to make sound decisions, capitalize on opportunities, and attract investors. In her work, [Penrose \(1959\)](#) advocates for a participatory management style that involves distributing the task of decision-making among the available

talent pool, thereby harnessing the full potential of the organization. On the other hand, [Greiner \(1972\)](#) proposes a management style tailored to each stage of growth, wherein managers are equipped to handle complex responsibilities. This suggests that managers with the requisite financial knowledge possess the capacity to effectively steer the growth trajectory of the enterprise.

According to the research conducted by [Ibua et al. \(2023\)](#), it has been emphasized that in order to ensure the effectiveness and efficiency of the staff members, they must possess the necessary skills and knowledge. Acquiring these attributes can only be accomplished through the process of continuous learning and development. However, it has been observed that a significant number of small and medium-sized organizations, commonly known as SMEs, tend to neglect the importance of providing proper training and development opportunities to their staff members. Consequently, this lack of investment in staff training and development negatively impacts the overall performance of these organizations, leading to subpar outcomes and results. This phenomenon can be clearly observed when analyzing the performance of certain SMEs, which is characterized by poor performance and underachievement in various areas.

[Kolvereid and Bullvag \(1996\)](#) assert that in order for an enterprise to achieve a high growth rate, the entrepreneur must possess a high level of education. However, [Njoroge \(2013\)](#) challenges this notion by arguing that the level of education is not the sole determinant of enterprise growth, citing examples of uneducated entrepreneurs who have achieved prosperity and educated ones who have failed to propel their enterprises to higher levels of growth.

According to [Warue and Wanjira \(2013\)](#), and [Fatoki \(2014\)](#), it is opined that MSEs (Micro and Small Enterprises) can acquire the necessary knowledge on financial management through business training, enabling them to effectively lead their businesses towards the next phase of growth. This assertion highlights the significance of equipping MSEs with the requisite financial acumen to navigate the complexities of managing and expanding their enterprises.

In summary, in the realm of medium and small enterprises (MSEs), access to financial resources proves pivotal for success and expansion, playing a significant role in influencing the broader economy. Limited access to formal credit channels leads many MSEs to rely on informal lenders, exposing them to financial constraints and high interest rates. This reliance is compounded by a lack of knowledge about banking services, hindering their ability to align financial products with specific business needs. Financial literacy emerges as a crucial factor, as highlighted by [Yavuzaslan et al. \(2023\)](#), emphasizing the cultural influence on business behavior. For MSEs, cultivating financial literacy becomes essential to navigate challenges and foster growth.

Moreover, the absence of expertise in fundamental

financial practices, such as bookkeeping and budgeting, further impedes MSE growth. Frank Wood (2010) emphasizes that financial records are akin to a guiding tool for a business, enabling accurate profit calculation, performance monitoring, and presentation to lending institutions. Budgets, described by Nugus (2006) as indispensable tools for managing resources, become less effective without the necessary knowledge, limiting profitability and overall business growth. The institutional barriers and challenges faced by MSEs, as noted by Muthiah and Venkatesh (2012), underscore the need for strategic interventions.

Recognizing the pivotal role of financial literacy, scholars like Penrose (1959) and Greiner (1972) assert that the owner's financial skills are primary drivers of enterprise growth. Idua et al. (2023) emphasize the importance of continuous learning and development for staff efficiency, an aspect often overlooked by SMEs. The level of education, while considered by some as a growth determinant, is challenged by Njoroge (2013), highlighting instances of uneducated entrepreneurs achieving prosperity. Finally, the consensus among Warue and Wanjira (2013), and Fatoki (2014) underscores the role of business training in equipping MSEs with financial acumen, enabling effective leadership for the next phase of growth.

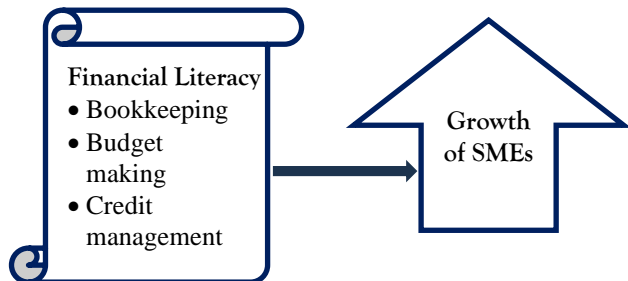


Figure 1: Financial literacy and SMEs growth

Figure 1 outlines a conceptual framework illustrating the intricate relationship between financial literacy and the economic growth of Small and Medium Enterprises (SMEs). At the core of this framework is the overarching concept of financial literacy, denoting a comprehensive understanding of financial management within SMEs. The three key components branching from financial literacy—bookkeeping, budget making, and credit management—emphasize critical skills that contribute to the overall economic growth of SMEs. Bookkeeping involves maintaining detailed records of financial transactions, providing insights into profits, product performance, and asset-liability tracking. Budget making is identified as a fundamental practice for SMEs, serving as a strategic tool for planning future activities, setting targets, and managing available resources. Credit management highlights the importance of skillfully handling credit, allowing SMEs to access financial resources responsibly, fueling their growth. The directional arrows in the figure signify the causal relationship, suggesting that a higher level of financial

literacy, encompassing adept bookkeeping, effective budget making, and proficient credit management, directly influences and contributes to the economic growth of SMEs. This framework underscores the significance of financial knowledge and skills in empowering SMEs to make informed decisions and optimize their financial strategies for sustainable growth.

5. Summary and Conclusions

MSEs contribute significantly to employment and GDP in many nations, including over 90% of the labor force in Kenya. However, despite their importance, MSEs face challenges such as limited access to credit, ineffective marketing strategies, and a lack of skilled personnel. The research aims to comprehensively understand the intricate relationship between financial literacy and the growth trajectory of MSEs in Kenya.

The theoretical framework incorporates enterprise growth theories, emphasizing the stages of growth proposed by Larry Greiner, and the resource-based view theory, highlighting the importance of internal and external resources for enterprise growth. The conceptual framework outlines key themes related to financial literacy, including budgetary control, bookkeeping, debt management, and knowledge of banking services.

The empirical review reveals that MSEs, crucial for economic impact, often face challenges in accessing financial resources, resorting to informal lenders with limited financial support and high interest rates. The lack of knowledge about banking services, bookkeeping, and budgeting also impedes their growth. The literature review suggests that financial literacy plays a pivotal role in MSE growth, with the owner's financial skills and decision-making abilities being primary drivers. Education is considered a factor, but not the sole determinant, and business training is identified as a means for MSEs to acquire financial management knowledge.

In conclusion, the research underscores the vital role MSEs play in Kenya's economy and the challenges hindering their growth. The study focuses on financial literacy as a key factor influencing MSE growth. The theoretical frameworks provide a foundation for understanding the stages of enterprise growth and the importance of resources. The empirical review highlights the practical challenges faced by MSEs, emphasizing the need for enhanced financial knowledge.

The findings from this research are expected to contribute valuable insights into the complex interplay between financial literacy and the growth trajectory of MSEs in Kenya. The recommendations stemming from this study could inform policies and interventions aimed at addressing the identified challenges, ultimately fostering a more conducive environment for the sustained growth of MSEs and, by extension, contributing to Kenya's overall economic development.

6. Recommendations

These recommendations, if implemented collaboratively by relevant stakeholders, have the potential to create a more favorable environment for the sustained growth of MSEs consequently contributing to the overall economic development of Kenya.

Develop and implement targeted financial literacy programs tailored to MSE owners and managers. These programs should focus on enhancing skills in budgetary control, bookkeeping, debt management, and understanding banking services. Collaborate with educational institutions and industry experts to deliver comprehensive training sessions.

Implement measures to enhance MSEs' access to formal credit facilities. This could involve collaborating with financial institutions to create specialized financial products for MSEs and introducing government-backed initiatives to reduce perceived risks for lenders, encouraging them to provide more financial support.

Facilitate the adoption of technology within MSEs to improve marketing strategies and broaden market reach. Provide targeted support and training programs to enhance digital marketing skills, online presence, and e-commerce capabilities, ensuring MSEs can effectively compete in the modern business landscape.

Encourage collaborative partnerships between MSEs and larger enterprises. These partnerships can facilitate knowledge transfer, mentorship programs, and shared resources, addressing skill gaps and promoting sustainable growth within the MSE sector.

Review and revise existing policies to identify and eliminate barriers hindering MSE growth. Implement policies that incentivize financial institutions to support MSEs, such as tax incentives, reduced regulatory burdens, and streamlined application processes for financial assistance.

Strengthen educational initiatives to equip MSE owners and managers with foundational business and financial management knowledge. Collaborate with educational institutions to integrate practical business and financial management modules into existing curricula, ensuring a well-prepared pool of entrepreneurs.

Establish a robust monitoring and evaluation framework to assess the impact of implemented interventions on MSE growth. Regularly review and update policies and programs based on feedback from MSEs, industry stakeholders, and evaluative data to ensure continued relevance and effectiveness.

Acknowledgment

We would like to express our gratitude to the journal editor and the anonymous reviewers for their valuable comments and suggestions that significantly improved the quality of this manuscript.

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Cite this article as: Njoki David Muiruri (2024). [Effect Of Financial Literacy on The Growth of Micro and Small Enterprises in Kenya](#). *African Journal of Commercial Studies*. 4(1),31-37. doi: [10.59413/ajocs/v4.i1.3](https://doi.org/10.59413/ajocs/v4.i1.3)