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A Study on the Relationship between Financial Literacy and Financing Preferences among Entrepreneurs

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ABSTRACT

Finance is considered to be the life giving element for all business houses. Importance of proper financial management is known by everyone. Author studied about the relationship of financial literacy and the borrowal behaviours of women entrepreneurs and about their choices for financing. Study found that there exists a negative relationship between the finance education earned by a person and his debt behaviour. Author suggests proper financial literacy trainings to update the financial skills of entrepreneurs to make the enterprises good for the society.

Keywords: Financial literacy, debt behaviour, Financial knowledge.

INTRODUCTION:

Finance is considered to be the lifeblood of all businesses as they need finances for meeting contingencies ass well as to meet the daily needs. Expansion of business units as well as daily management of the businesses is revolved around finance. Only finance can convert the dreams and ideas of entrepreneurs into reality. Finance simply doesn't mean the money available with you in hand, it can be borrowed too. When money is needed, equity, debt or a hybrid of the two can be resorted to by an entrepreneur. Money borrowed by one party from another is called as debt. Debt is an agreement between the borrowing party and the lending party whereby the borrower agrees to repay the borrowed money back along with interest on a future date. This is an alternative to equity financing, where interest in ownership will be shared in return for the amount provided. Equity financing gives a claim on future earnings without the need to be paid back except on the situations of winding up or on liqudation. Even the richest person will have some portion of debt if they are making proper use of their finances. But with the increased use of debt, an entrepreneur will have the risk of defaulting without having sufficient cashflow to meet the expenses. Enterpreneurs who make use of debt for various needs should understand the financial cost of the credit that they are using. Credit card debt, mortgage loans, hire purchase loans, and consumer loans are the different types of debt. If proper credit use is not undertaken,then that might lead to the failure of the business. Consequences of the failure in making payments for debts can be dangerous. But if you are well planned about the proper use of debt, you will be in an advantageous position. Previous research in this area has shown that financial competence is associated with the ability to make better decisions regarding credit usage. Financial literacy indicates the financial competence of the individual and their ability in understanding the concepts and its applications. It was therefore felt a need to study about the relationship of financial literacy and debt behavior to have a balance between over indebtedness and debt.

SIGNIFICANCE OF THE STUDY:

Government is in the line of encouraging businesses to use debt by giving a chance to deduct the interest on debt from the taxes that they have to pay to the government. 35 % tax rate would definitely encourage

entrepreneurs to use debt than equity financing. Debt is a form of arrangement which gives you complete control of your organization but it should be judiciously used. If debt availed is not handled properly, then that might affect the enterprise severly. From the point of view of the investor, equity is more riskier because company is not legally obliged to pay any regular return in the form of dividends to them and shareholders will be the one loosing their investments if a firm goes bankrupt. For a debt, there is a mandatory obligation to pay interest regularly failing which the lenders will demand and take appropriate action to collect the same. Inability to pay the debts on time will give a clue about the financial condition of the organization. Rate of return on equity will be very high nearly 10 % whereas rate of return on debt will not be very high after considering the tax advantage. But borrowing more than their capacity is lethal for all organizations as it will create a situation in which lenders will take charge of the assets pledged. The usual indicator of the indebtedness refers to the defaults in payments, number of loan repayment obligations and the debt burden indicators. For a good debt, it is important to have the financial reserves to pay for meeting the necessary expenses, while having the liquidity to meet for the repayment of loans. Lusardi, A. and Tufano, P. (2009) in their Working paper “Debt literacy, financial experiences, and overindebtedness” published in the National Bureau of Economic Research reports that individuals with lower levels of debt literacy shows the tendancy to transact in high-cost, after incurring huge fees and using high-cost borrowing. The findings of the research conducted by [18] suggest that a consumer with a higher level of financial literacy is less likely to
exhibit excessive borrowing behavior. A decision to borrow excessive debt than one is capable to repay may invite troubles for the borrowers creating over-indebtedness and loss of credibility for the borrowers. Gianni et al.,(2007) points out that consumption ratio will decline drastically for a over indebted household compared to a normal household and they will have to cut down their expenses for meeting the huge expenses of the debt. This research paper attempts to measure the effects caused by financial literacy on the debt behavior of women entrepreneurs.

LITERATURE REVIEW:

Sanja Ajzerle et. Al (2013) studied about the relationship between the financial capability and the effective use of debt among the 680 households of Australia and came to a conclusion that people with greater financial capability exhibits a better personal debt management behavior than others with lower financial capability. But author is also of the opinion that overall debt usage effectieveness was not that high among the respondents.
Norvilitis et al. (2006) is of the view that financial attitude of the student has a significant role in determining the debt levels after studying about the money attitude, impulsivity, locus of control, life satisfaction and stress among the college students in New York. Personality variables among college students were found to be unrelated with the levels of debt but it had association with the attitude towards money.
Monticone C (2010) studied about the impact created by wealth on the financial literacy of a person among Italians. Author reached into a conclusion that though the level of financial literacy among Italians is low, It varied according to the demographic features of the population. He points out that there is a positive relationship between the financial assets of a person and the investments in financial education by a person. Though there exists a positive relationship,the values are only feeble.
Lusardi A (2009) analyzed a sample of Americans to study about their financial experience, debt literacy, and their judgments about the level of their indebtedness. Awareness of fundamental concepts related to debt was tested using a set of questions. Respondent’s experience about borrowing was also measured to know about the financial experience. A strong relationship between debt literacy and both debt loads and financial experiences was found. Financially illiterate people were not able to judge their debt position.
Syed Ahmad Mustafa Shah (2015) researched to find out whether proper financial management could affect the profitability and viability of the business in the long run. Proper financial management means procurement and utilization of funds from the cheapest sources to make the best use for better profits. It was suggested that business houses can improve profitability by improving the financial management practices.
Meta Brown (2016) Studied about the results of exposure to financial training among young Americans who otherwise depend too much on debt. Those who learnt mathematics and finance depended less on debt and exhibited better repayment behavior than others who are not trained. Economics training increased the chances of holding outstanding debt and repayment difficulties also prevailed.
John Gathergood (2011) Studied about the relationships that exists between financial literacy ,self-control and over-indebtedness on consumer credit debt. A household survey was done among the U.K. consumers. He came to a conclusion that non payment of consumer credit and excessive financial burdens are positively related to

the lack of self-control and lack of financial literacy. He also points out that consumers who lack self-control are more likely to experience income shocks, sudden credit withdrawals and contingency expenses on durables.

OBJECTIVES OF THE STUDY:

- To study about the financing preferences of women respondents.
- To determine whether the respondent's debt behaviour will differ according to their financial literacy.
- To study about the association of the financial literacy and area of the respondents.

HYPOTHESES OF THE STUDY:

- There is no significant difference between the financial literacy of rural and urban population
- There is no association between debt behavior and financial literacy of respondents.

METHODOLOGY:

The study is based on the primary data, derived through sample survey. The sample designs were based on random sampling. Data collected through survey were supplemented with secondary data which were found relevant to make the study more significant. Chi-square tests were administered at 5% level of significance for testing the opinions of respondents.

ANALYSIS AND INTERPRETATION:

Respondents were asked about the preferences towards various sources of financing after categorizing it as 1 = very low preference, 2 = low preference, 3 = neither low nor high preference, 4 = high preference, and 5 = very high preference.

Table No 2 (a): Financing preferences by women respondents

Categories	Very high preference (5)	High preference (4)	Medium(3)	Low preference (2)	Very low preference (1)
Family friends and relatives	28	10	01	05	06
Export-import finance	05	08	05	12	20
Non-banking financial institutions	25	08	05	03	09
Trade credit	20	08	06	08	08
Funds from other companies	02	05	12	12	19
Funds through fixed deposit	22	05	08	08	07
Long-term government financing schemes	20	11	12	05	02
Cash credit	08	05	08	10	19
Long-term bank loans	12	05	15	07	11
Short-term bank loans	20	11	09	05	05
Money lenders	38	02	01	04	05

Categories	Very high preference (5)	High preference (4)	Medium(3)	Low preference (2)	Very low preference (1)
Bank overdrafts	43	01	01	02	03
Retained earnings	23	10	09	05	03
Funds from group companies	05	04	06	03	32
Owner funds	19	19	05	02	05
Advance against shares	04	02	01	02	41
Gold loan	13	12	12	8	5

Table No 3: Likerts scale

Categories	Very high prefer ence (5)	High prefere nce (4)	Mediu m(3)	Low preferen ce (2)	Very low prefer ence (1)		Avg response
Family friends and relatives	140	40	03	10	06	199	3.98
Export-import finance	25	32	15	24	20	116	2.32
Non-banking financial institutions	125	32	15	06	09	187	3.74
Trade credit	100	32	18	16	08	174	3.48
Funds from other companies	10	20	36	24	19	109	2.18
Funds through fixed deposit	110	20	24	16	07	177	3.54
Long-term government financing schemes	100	44	36	10	02	192	3.84
Cash credit	40	20	24	20	19	123	2.46
Long-term bank loans	60	20	45	14	11	150	3
Short-term bank loans	100	44	27	10	05	186	3.72
Money lenders	190	08	03	08	05	214	4.28
Bank overdrafts	215	04	03	04	03	229	4.58
Retained earnings	115	40	27	10	03	195	3.9
Funds from group companies	25	16	18	06	32	97	1.94
Owner funds	95	76	15	04	05	195	3.9
Advance against shares	20	08	03	04	41	76	1.52
Gold loan	65	48	36	16	05	170	3.4

Bank overdraft is the most favourite financing option favoured by entrepreneurs. Median value is 3.54 and those options which are above the median values were selected as the preferred choices among the entrepreneurs. Bank overdrafts ,Owner funds , Retained earnings , Money lenders , Short-term bank loans, Long-term government financing schemes, Non-banking financial institutions and Funds from family friends and relatives were preferred over other choices of financing.

Association of financial education levels and borrowals of the respondents:

An optimum debt equity ratio with optimum leverage will be desired by all the entrepreneurs. A very high debt equity ratio is a sign that the company's performances is not up to the expected levels in generating sufficient cash flows to meet the fixed financial obligations of the company. In all business houses, consistently entrepreneurs will have to be careful with their financial decisions because frequently there will be due dates, finance charges and penalties attached along with due dates. It is important to make the right decisions regarding major purchases and investments to run the businesshouses at a profit without incurring losses. It is important for the entrepreneurs to pay the bills on time without drowning in debt. At the same time, having a low debt equity ratio is an indication that the leveraging possibilities are not taken care of in an appropriate manner. It is important to have an optimum one. Responsible decisions which can affect the life of the business can come only from a person having knowledge in finance.

With this thought in mind,a study was undertaken to find about the association of financial knowledge gained through financial education with the borrowals of an entrepreneur.

Results obtained after the study can be seen below:

Correlations			
		monthly outstanding debt of respondents	**marks obtained**
monthly outstanding debt of respondents	Pearson Correlation	1	-.418**
	Sig. (2-tailed)		.003
	N	50	50
marks obtained	Pearson Correlation	-.418**	1
	Sig. (2-tailed)	.003	
	N	50	50
**. Correlation is significant at the 0.01 level (2-tailed).			

It can be seen from the results, that there is a negative correlation between the financial knowledge of the respondents and the monthly borrowals of the entrepreneurs. For a financially literate person debt level is found to be low.

Correlations			
		marks obtained	**Area of the student**
marks obtained	Pearson Correlation	1	.131
	Sig. (2-tailed)		.365
	N	50	50
Area of the student	Pearson Correlation	.131	1
	Sig. (2-tailed)	.365	
	N	50	50

It can be seen from the results that there exists a positive relationship between the financial knowledge of a person and the area in which he resides.

CONCLUSION:

Financial literacy is the ability of a person which gives him the necessary knowledge to tackle lifes financial matters after having proper knowledge of its impact on their lifes. From the analysis, it can be understood that financial literacy of a person has an impact on his borrowing behaviour. For business houses, it is important to know about the sources of funds to make use of funds when a need arises,and for assessing the financial risk tolerance.Area in which a person resides also has an impact on his scores obtained based on the financial literacy of respondents. So it is important to provide financial training facilities for the entrepreneurs to improve their efficiency in fund management for the prosperity of the business and for the progress of the society in which the entrepreneur is living.

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