THE IMPACT OF FINANCIAL LITERACY ON THE SUSTAINABILITY AND PROFITABILITY OF SMALL AND MEDIUM ENTERPRISES (SMES) IN LAGOS STATE, NIGERIA

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Abstract
Small and Medium Enterprises (SMEs) form about 96% of Nigeria's businesses and are essential to job creation and economic growth, especially in Lagos State. Despite their significance, many SMEs in Lagos struggle with sustainability and profitability due to low levels of financial literacy among owners and managers. This paper examines the role of financial literacy in improving SME performance, using Hawley's Risk Theory of Profit as the guiding framework. The review highlights key components of financial literacy, such as budgeting, saving, investing, credit management, taxation, and risk management, and explains how they influence business decisions. The study identifies major barriers to financial literacy, including low educational background, limited training opportunities, digital gaps, and poor record-keeping practices. Findings indicate that financial literacy enhances access to finance, strengthens decision-making, improves cost control, ensures tax compliance, and increases business resilience. The paper recommends integrating financial education into entrepreneurial programs, expanding access to financial tools, and promoting policy incentives to support SME development in Lagos State.

Keywords: Financial Literacy, Profitability, Sustainability, and Small and Medium Enterprises (SMEs)

Introduction
Small and Medium Enterprises (SMEs) are the backbone of Nigeria's economy, accounting for an estimated 96% of businesses and contributing significantly to employment generation and poverty alleviation. In Lagos State, Nigeria's commercial capital and a major hub for entrepreneurial activity, SMEs play a particularly vital role in driving economic growth and innovation. However, despite their importance, many SMEs in Lagos struggle with issues related to sustainability and profitability, often leading to business failure within the first few years of operation. A critical factor underlying these challenges is the limited level of financial literacy among SME owners and managers. Financial literacy, which encompasses the knowledge and skills required to make informed and effective decisions regarding financial resources, is increasingly recognized as a key determinant of business success. It affects an enterprise's ability to manage cash flow, access credit, plan for growth, and make sound investment decisions. In the absence of adequate financial literacy, SME operators may mismanage resources, fall into unsustainable debt, or fail to comply with tax and regulatory requirements, jeopardizing both profitability and long-term survival. In Lagos State, the dynamic but competitive business environment further heightens the need for financial competence among entrepreneurs. Yet, studies and anecdotal evidence suggest that a large proportion of SME operators possess only rudimentary financial knowledge. This gap has implications not only for individual businesses but also for broader economic development and financial inclusion initiatives in the state.

This position paper examines the pivotal role of financial literacy in enhancing the sustainability and profitability of SMEs in Lagos State. It argues that improving financial literacy among SME operators is not just a desirable policy goal but an essential strategy for fostering a resilient and inclusive entrepreneurial ecosystem. Through a critical analysis of existing data, stakeholder perspectives, and case studies, the paper seeks to demonstrate how targeted financial education programs and supportive policy frameworks can empower SMEs to thrive in a competitive economic landscape.

Literature Review

Theoretical Framework

Hawley's Risk Theory of Profit

The risk theory of profit was propounded by F. B. Hawley in 1893. He believed that those who have the risk ability in the dynamic production have a sound claim on the reward called profit. Risk in business may arise due to obsolescence of a product, sudden fall in prices, introduction of a better substitute by a competitor, and risk due to fire, war, etc. Hawley considers risk-taking as an inevitable element of production, and those who take risks are more likely to earn larger profits. According to Hawley, profit is simply the price paid by society assuming business risk in excess of predetermined risk. Hawley categorized profits into two parts, namely: the compensation for the actuarial loss suffered due to several classes of risks assumed by the entrepreneur, and secondly, profit representing the inducement to bear the consequences due to the exposure of risk in the entrepreneurial adventures. The theory is based on the assumption that profits arise from factor ownership, as long as the ownership involves risk. Hawley believes that an entrepreneur has to assume risk to earn more and more profit. In the case of the absence of risk, an entrepreneur would cease to be an entrepreneur and would not receive any profit. According to this theory, an entrepreneur coordinates other factors of production like capital, labour, land etc. and initiates production. During the time of production, there are so many changes to be reported. There can be situations where total sales may fall short of total cost of production making the entrepreneur to run into loss. An entrepreneur undertakes risks for the purpose of getting a reward in the form of profit. In this theory profits arise from uninsured risk. It is certain that no entrepreneur will like to undertake risk if he gets only the normal return. Therefore, the reward for risk taking must be higher than the actual value of the risk. Also, it has been said that the more risky the business, the higher is the expected profit rate. It can therefore be concluded that it is the uninsured risk from which the profit arises and until the product is sold an entrepreneur's amount of reward cannot be determined. Hence, the profit is residue and therefore his theory is also called a Residual Theory of Profit.

Conceptual Review

Concept of Financial Literacy

Financial literacy is the ability to understand and effectively use various financial skills, including personal financial management, budgeting, investing, and the principles of money. It is a critical life skill that empowers individuals to make informed decisions about their finances and achieve financial well-being. Financial literacy refers to the knowledge and understanding of financial concepts and the ability to use such knowledge to make effective decisions regarding the use and management of money. It encompasses skills such as: Budgeting, saving, investing, borrowing, understanding credit, and planning for retirement. A financially literate individual can confidently navigate complex financial systems and avoid pitfalls such as debt traps and poor investment choices. One of the striking things about the literature is that financial literacy has been variably defined as a specific form of knowledge, the ability or skills to apply that knowledge, perceived knowledge, good financial behavior, and even financial experiences (Hung, Parker, & Yoong, 2009). According to OECD/INFE (2020), financial literacy encompasses awareness, knowledge, skills, attitudes, and behaviors necessary to make sound financial decisions and achieve financial well-being. Their study likewise reviews the lack of knowledge in personal finance, intricate financial situations, in addition to a large range of choices for making decisions on financing, and time constraints on learning about personal finance, which is a barrier to financial literacy. Recent studies emphasize that financial literacy among entrepreneurs extends beyond personal finance and includes the ability to interpret financial information, manage business finances, and make strategic decisions that enhance firm performance (Agyapong & Attram, 2019). Recent studies recognize financial literacy as a core managerial competency required for effective SME management, influencing essential functions such as strategic planning, cash-flow monitoring, and enterprise growth (Amari, Hassan, & Hidayat, 2022). Entrepreneurs are continually involved in decisions regarding resource acquisition, allocation, and utilization, and these decisions carry financial implications. As a result, contemporary research emphasizes that financial literacy is indispensable for entrepreneurs who must make informed financial choices that enhance business sustainability and profitability (Agyapong, Agyemang, & Boateng, 2021).

Components of Financial Literacy

1. Budgeting: Budgeting involves creating a plan for how to spend and save money. A budget helps individuals track income, control spending, and allocate resources efficiently.
2. Saving and Emergency Funds: Saving is essential for short-term needs and long-term goals. Financial literacy encourages the habit of saving regularly and building an emergency fund to cover unexpected expenses.
3. Investing: Understanding investment options, such as stocks, bonds, mutual funds, and real estate, is a key part of financial literacy. It also involves understanding risk, return, and diversification.
4. Credit and Debt Management: This includes understanding how credit works, how to read credit reports, the importance of credit scores, and the responsible use of credit cards and loans.
5. Insurance and Risk Management: Financially literate individuals recognize the importance of protecting themselves against financial loss through insurance policies like health, life, auto, and home insurance.
6. Retirement Planning: Planning for retirement involves understanding retirement accounts, pensions, and the power of compound interest. Early and consistent contributions to retirement savings can significantly impact financial security in old age.
7. Taxation: A good grasp of how taxes work, including income tax, sales tax, and capital gains tax, enables individuals to make tax-efficient decisions and comply with legal obligations.

The term Sustainability of SMEs

This involves the long-term survival, resilience, and responsible growth of small businesses, including their capacity to withstand economic shocks, adopt innovations, and fulfill environmental and social responsibilities. Small and Medium-sized Enterprises (SMEs) play a vital role in the global economy, contributing significantly to employment, innovation, and economic development. However, in the face of mounting environmental challenges, social inequalities, and economic volatility, the sustainability of SMEs has become a critical issue. In this context, sustainability refers to the ability of SMEs to operate in a manner that balances economic performance, social responsibility, and environmental stewardship to ensure long-term viability and minimize negative impacts on society and the planet. According to Johnson and Schaltegger (2022), SME sustainability involves integrating economic performance, social responsibility, and environmental stewardship into business operations. Similarly, Oladejo and Akanbi (2021) define SME sustainability as the ability of a business to grow in terms of revenue, market share, and operational scale without compromising stability. Understanding sustainability in SMEs is often viewed through three interconnected pillars:

1. **Economic Sustainability**
   i. Ensuring the long-term financial health of the business.
   ii. Improving productivity, innovation, and competitiveness.

2. **Environmental Sustainability**
   i. Minimizing ecological footprints.
   ii. Using resources efficiently and reducing waste, emissions, and pollution.

3. **Social Sustainability**
   i. Ensuring fair labor practices.
   ii. Contributing positively to communities and upholding ethical standards.
   For SMEs, sustainability is not just about compliance or corporate social responsibility (CSR), it is about resilience, growth, and survival in an increasingly sustainability-conscious market.

Importance of SMEs Sustainability

1. Access to Markets and Finance: Sustainable practices can improve credibility and help SMEs access international markets and secure funding from institutions with ESG (Environmental, Social, Governance) criteria.
2. Cost Reduction: Resource-efficient practices reduce costs through energy savings, waste minimization, and efficient supply chain management.
3. Regulatory Compliance: Many governments are tightening environmental and social regulations. Early adoption of sustainable practices ensures compliance and reduces legal risks.
4. Customer Expectations: Consumers are increasingly favoring brands with transparent, ethical, and green practices. Sustainable SMEs are more likely to build brand loyalty.
5. Resilience to Disruption: Businesses with sustainable models are better prepared for economic shocks, supply chain disruptions, and climate-related risks.

The term Profitability of SMEs

Profitability is a fundamental indicator of a business's financial health and long-term viability (World Bank, 2020). For Small and Medium-sized Enterprises (SMEs), which represent the majority of businesses globally, profitability is not only a sign of success but also a prerequisite for survival and growth. Unlike large corporations with diverse revenue streams and capital reserves, SMEs often operate with limited resources, making profitability even more critical to their sustainability. Profitability refers to a business's ability to generate income relative to its revenue, operating costs, and other expenses over a given period (OECD/INFE, 2020). It is the ability of an SME to generate income relative to its costs and expenses, reflecting efficiency in resource utilization and operational effectiveness (Oladejo & Akanbi, 2021). In SMEs, profitability reflects how well the enterprise is managed, how competitive it is in the market, and how it balances cost control with revenue generation.

Key Profitability Metrics for SMEs

1. **Gross Profit Margin** = $\frac{\text{Gross Profit}}{\text{Net Revenue}} \times 100$
2. **Operating Profit Margin** = Operating Profit = Gross profit – Operating Expenses or
   Revenue – Cost of Goods Sold – Operating Expenses.
3. **Net Profit Margin** = $\frac{\text{Net Profit}}{\text{Net Revenue}} \times 100$

4. **Return on Assets (ROA)** = $\frac{\text{Net Profit}}{\text{Total Assets}} \times 100$

5. **Return on Equity (ROE)** = $\frac{\text{Net Profit}}{\text{Shareholders'}} \times 100$

Determinants of Profitability in SMEs

1**. Revenue Generation**

i. Sales volume and pricing strategy.
ii. Market demand and customer base.
iii. Product or service innovation.

2. **Cost Management**

i. Efficient procurement, production, and operations.
ii. Control of overheads and unnecessary expenses.

3. **Market Conditions**

i. Industry trends, competition, and consumer behavior.
ii. Access to suppliers and distribution channels.

4. **Business Strategy**

i. Differentiation, niche targeting, or cost leadership.
ii. Marketing effectiveness and customer retention.

5. **Financial Management**

i. Cash flow management and investment decisions.
ii. Use of financial tools and accounting systems.

6. **Access to Finance**

i. Capital structure and debt management.
ii. Availability of affordable credit or investor funding.

Challenges Limiting Financial Literacy among SMEs

1. Low Educational Background: Many SME owners lack formal education, making it difficult to grasp financial concepts.
2. Limited Financial Education Programmes: Financial literacy programs are not widely integrated into SME development initiatives.
3. Cultural and Language Barriers: In multilingual or diverse societies, financial education materials may not be available in local languages or tailored to local contexts and this will therefore limits comprehension and application of financial concepts among SMEs owners from different cultural backgrounds.
4. Digital Divide: The lack of access to digital financial tools and literacy widens the knowledge gap**.**
5. Time Constraints: SMEs owners are typically overwhelmed with day-to-day operational tasks and may not have the time or motivation to pursue financial training or education. Financial skills are deprioritized, leading to continued ignorance and potential business mismanagement.
6. Poor Record-Keeping Practices; Many SMEs do not maintain proper financial records, making it difficult for them to track financial performance or seek support in understanding their finances.

Impact of Financial Literacy on SMEs Sustainability and Profitability in Lagos State

1. Improved Decision-Making: Entrepreneurs with higher financial literacy demonstrate better decision-making concerning budgeting, pricing, sourcing, and investing. They can assess risks, forecast cash flow, and plan for long-term growth.
2. Enhanced Access to Finance: Lenders and investors are more inclined to support businesses that exhibit sound financial practices. Financially literate SME owners can develop bankable business plans and maintain transparent financial records, increasing their eligibility for credit and investment.
3. Business Sustainability: With financial knowledge, SMEs can manage debts, reduce operating costs, and reinvest profits strategically. This enhances resilience to market shocks, inflation, or currency fluctuations, factors common in the Nigerian economy.
4. Profitability Metrics: SMEs with financial literacy tend to track performance using indicators like gross profit margin, return on investment (ROI), and net income, thereby identifying loss-making areas and implementing corrective strategies in time.
5. Strategic Planning and Risk Management: financial literacy empowers SMEs owners to set realistic goals, forecast revenues and expenditures, and plan for contingencies. It also helps in identifying financial risks early and taking preventive measures. For example, businesses that maintain emergency funds or insurance plans based on sound financial advice are more likely to survive economic shocks.
6. Better Pricing and Cost Control: Financial literacy helps SMEs owners understand the relationship between costs, pricing, and profits. This allows them to set competitive prices that cover expenses and yield profits, while also identifying cost-saving opportunities. A financial literate business owner can perform break-even analysis to avoid underpricing or overpricing.
7. Efficient Tax Planning and Compliance: SMEs that understand basic tax regulations are more likely to comply with tax laws, take advantages of allowable deductions, and avoid penalties.

Recommendations

To harness the benefits of financial literacy for SMEs development in Lagos State, the following policy actions are recommended:

1. Integrate Financial Education into Entrepreneurial Training: Government and private-sector programs should make financial literacy a core module in vocational and business development initiatives.
2. Expand Access to Financial Tools: Support SMEs in adopting accounting and financial planning software through subsidies or partnerships with fintech providers.
3. Promote Public-Private Partnerships: Banks, NGOs, and educational institutions should collaborate to deliver tailored financial literacy campaigns targeting informal and formal SME sectors.
4. Regulatory Incentives: Provide tax breaks or funding incentives for SMEs that participate in certified financial literacy programs.
5. Monitor and Evaluate Impact: Establish a framework to measure the correlation between financial education and business performance metrics, ensuring continuous improvement.

Conclusion

Financial literacy is not merely a desirable skill but a necessity for the survival and growth of SMEs in Lagos State. As the economic heartbeat of Nigeria, Lagos must prioritize financial education to unlock the full potential of its entrepreneurial ecosystem. By equipping SME owners with financial knowledge, stakeholders can build more resilient, profitable, and sustainable businesses, ultimately contributing to national development goals and inclusive economic prosperity.

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