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An Assessment of the Impact of Financial Literacy on the Profitability of SMEs in Kiambu County, Kenya

Authors: [1]Fathi Asad Abdi, [2]Job Omagwa and [3]Edward Wasike
[1&3]Kiriri Women's University of Science and Technology, Kenya. **Website:** www.kwust.ac.ke
[2]**Kentatta University. Website:** www.ku.ac.ke
Correspondance: Fathi Asad Abdi. **Email:** fathiasad123@gmail.com

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Abstract: *Kenya's economy depends heavily on small and medium-sized businesses (SMEs), but many of them still have low profitability and high failure rates because of poor financial management. This study evaluated how financial literacy affected SMEs' profitability in Kenya's Kiambu County. The study was guided by the Profit Maximization Theory, which emphasizes that firms make rational decisions to maximize net profits. An explanatory research design and a mixed methodology were employed to examine how financial literacy influences the profitability of SMEs in Kiambu County, Kenya. Data were gathered from a sample of 73 SMEs chosen by stratified random sampling using an explanatory research design. The results showed that SMEs' budgeting, saving, investing, and diversification practices are greatly improved by financial literacy, which raises profitability. Regression analysis revealed that 65.9% ($R^2 = 0.659$) of the variation in profitability can be explained by financial literacy, while the correlation results demonstrated a strong and statistically significant positive relationship between financial literacy and profitability ($r = 0.812$, $p < 0.01$). These findings support the idea that financially literate business owners are better at-risk mitigation, resource management, and financial decision-making that enhances company performance. The study came to the conclusion that one of the main factors influencing SME profitability and long-term viability is financial literacy. The study recommends digital platforms and mentorship programs to promote good financial management practices that support profitability and growth, as well as improving financial literacy training and incorporating financial education into SME development programs.*

Keywords: *Financial Literacy, Profitability, Small and Medium Enterprises (SMEs), Microfinance, Credit*

1.1 Introduction

According to the OECD (2020), financial literacy is the capacity to comprehend and apply a range of financial skills, such as investing, budgeting, and personal financial management, in order to make wise and sensible decisions. It gives people and business owners the skills and information they need to effectively and sustainably manage their financial resources. Profitability, on the other hand, is a crucial measure of a company's performance and sustainability since it describes its ability to make money in relation to its costs over a specific time period (Pandey, 2019). By creating jobs, encouraging innovation, and boosting national income, small and medium-sized enterprises (SMEs) are commercial organizations that are essential to economic development (World Bank, 2020).

SMEs make up more than 90% of all businesses globally and account for roughly 50% of GDP and employment in many economies (OECD, 2020). Despite their significance, low profitability, restricted credit availability, and inadequate financial management are problems that many SMEs face globally. According to studies, financially literate business owners perform better as a company, make better decisions, and practice better money management (Lusardi & Mitchell, 2017). Consequently, international organizations like the World Bank and OECD have highlighted financial literacy as a crucial component for improving the competitiveness and sustainability of SMEs.

SMEs are widely acknowledged as the foundation of economic expansion and poverty reduction in Africa. They contribute roughly 40% of the continent's GDP and almost 80% of jobs (African Development Bank, 2021). However, low financial literacy, a lack of training in business management, and restricted access to reasonably priced credit put African SMEs under a lot of financial strain (Akinpelu, 2017). Microfinance institutions (MFIs) were created to close this gap by offering small-scale credit and other financial services to people and small businesses that are not able to access traditional banking systems (Rogg, 2018). However, research indicates that having access to microfinance by itself does not ensure increased profitability unless business owners have the necessary financial literacy to make efficient use of the money (World Bank, 2020).

Microfinance initiatives have emerged as crucial tools for empowering small enterprises and advancing financial inclusion in the East African region (Bennett & Sydney, 2022). The number of microfinance organizations providing microloans, savings accounts, and insurance products has increased significantly in Kenya, Uganda, and Tanzania. But according to research conducted in the area, a lot of small business owners still have trouble allocating resources and managing debt, primarily as a result of a lack of financial literacy (Geeta & Sivanand, 2023). It has been demonstrated that incorporating financial literacy instruction into microfinance programs greatly improves SME performance by enabling them to make better investment, saving, and budgeting choices.

SMEs play a crucial role in Kenya's economy, accounting for over 80% of job opportunities and roughly 33% of the country's GDP (KNBS, 2022). Despite their importance, many Kenyan SMEs fail within the first five years of operation and are not profitable (Kalui & Omwansa, 2019). Inadequate financial management abilities and restricted access to official credit are frequently blamed for this difficulty. By providing microloans, savings accounts, and microinsurance products, microfinance organizations have been instrumental in closing the funding gap. However, many SME owners who lack adequate financial literacy mishandle borrowed money or neglect to make repayment plans, which results in subpar business performance and insolvency (Waithaka, 2018). One of Kenya's most commercially and industrially active counties, Kiambu County is home to numerous SMEs in a variety of industries. Numerous financial service providers are available, but many SMEs in the county still face challenges with sustainability and profitability. This situation begs the question of whether SME owners' financial performance and decision-making are influenced by their levels of financial literacy.

1.2 Statement of the Problem

With over 80% of the working population employed by SMEs and a 40% GDP contribution, SMEs are essential to Kenya's economic growth (KNBS, 2022). Nevertheless, despite their significance, a large number of SMEs still experience low profitability and high failure rates; roughly 46% of them fail within the first year (KNBS, 2023). According to academics like Beck and Demirguc-Kunt (2016), this trend is caused by a lack of financial literacy, poor cash flow management, and restricted access to financing. Though they were created to fill these funding gaps, microfinance institutions (MFIs) such as Equity Bank, KWFT, and Faulu Kenya have had varying effects on the profitability of SMEs (Ledgerwood, 2013). Due to high interest rates and inadequate financial management, some studies report little to no effects, while others show positive results (Banerjee et al., 2015). Due to a lack of financial management expertise and low financial literacy, many SMEs in Kiambu County continue to struggle with profitability even with the presence of multiple MFIs. Major cities like Nairobi and Mombasa have received the majority of the attention in previous research (Wanjiru, 2018), leaving counties like Kiambu understudied. This disparity emphasizes the necessity of investigating the ways in which financial literacy affects the relationship between SME profitability and microfinance accessibility. Thus, the purpose of this study is to evaluate how financial literacy affects the profitability of SMEs in Kenya's Kiambu County.

1.3 Objective of the Study

The objective was to assess the effect of financial literacy on profitability of small and medium enterprises in Kiambu county, Kenya.

1.4 Scope of the study

The study looked at how important microfinance services credit, savings, insurance, and training—affect the profitability of SMEs from 2017 to 2024. Kiambu County was chosen because of its high concentration of SMEs in a variety of industries, including retail, services, and agriculture, as well as the county's rising need for financial services to help businesses grow. The results from Kiambu shed light on the ways in which microfinance can support the expansion of SMEs and regional economic growth.

1.5 Literature Review

In this section, theoretical and empirical literature on the effect of financial literacy on profitability of small and medium enterprises are presented.

1.5.1 Theoretical Literature

The Profit Maximization Theory, rooted in classical and neoclassical economic thought and formalized by economists such as Marshall (1890), asserts that businesses aim to make decisions that will maximize their net profits. This theory makes the assumption that the pursuit of the maximum return serves as the ultimate driving force behind all business decisions, including those pertaining to financing, pricing, and production. Profit maximization is not only a strategic goal but also a requirement for SMEs' survival and expansion, especially in developing nations (Pandey, 2019). This theory states that small- and medium- enterprises must consider profitability when assessing all available funding and investment options. The choice to use the loans and financial services that microfinance institutions (MFIs) provide to SMEs depends on whether the anticipated returns on borrowed capital outweigh the cost of borrowing. By offering the theoretical framework for comprehending how financial literacy affects the financial decision-making and profitability outcomes of SMEs, the Profit Maximization Theory directly informs the study "An Assessment of the Impact of Financial Literacy on the Profitability of SMEs in Kiambu County, Kenya."

1.5.2 Empirical Literature

Ho and Tan (2021) used ideas from behavioral economics theory, which holds that cognitive biases and personal beliefs have a big impact on financial decision-making, to investigate how financial literacy aids in the expansion of SMEs in Southeast Asia. According to their research, financial literacy aids in the reduction of these biases, empowering business owners to make more sensible and wise financial decisions. Using survey data from 250 SME owners in Singapore, Malaysia, and Thailand and a quantitative methodology, the researchers discovered that better financial management led to increased profitability for financially literate business owners. However, the study did not examine how particular microfinance services, like microloans, savings, and insurance, interact with financial literacy to affect overall profitability; instead, it concentrated primarily on financial literacy and SME growth. Choudhury and Singh (2020) examined how financial literacy affected Indian SMEs' profitability. The study made use of the theories of financial literacy and human capital. According to human capital theory, people with greater financial literacy are better able to make wise financial decisions, which enhances company performance. The theory of financial literacy highlights how business owners' comprehension of financial management techniques affects the profitability of their companies. 200 SME owners in both urban and rural India provided the data. SMEs with financially literate owners performed better, especially in cash flow management, budgeting, and making wise investment choices, according to their mixed-methods approach, which combined surveys and interviews. Data analysis for the study was done using Structural Equation Modeling (SEM), and the results showed that financial literacy significantly increased SME profitability.

Nyasha and Tawanda (2019) examined the function of microfinance organizations in Sub-Saharan Africa. The Microfinance Theory explains that by giving small loans to business owners and SMEs who cannot obtain traditional bank financing, microfinance institutions contribute to the reduction of poverty. SME owners and representatives of microfinance institutions in Ghana, Nigeria, and Kenya were interviewed. Microfinance services gave SMEs the necessary capital, which increased their profitability, according to qualitative research using case studies. Olawale and Akinpelu (2017), investigated the contribution of microfinance services to the expansion and profitability of SMEs in Nigeria. According to the Financial Intermediation Theory, financial institutions, such as microfinance banks, help money move from savers to borrowers, increasing economic efficiency and business profitability. 150 SMEs in Lagos State, Nigeria, provided the data. Regression analysis and surveys were used in their quantitative study, which concluded that microfinance services improved profitability and that financial literacy was essential for making efficient use of financial products.

1.6 Methodology

The study employed an explanatory research design to investigate the impact of microfinance services on the profitability of Small and Medium-sized Enterprises (SMEs) in Kiambu County, Kenya. This design was appropriate as it enabled the examination of causal relationships between the independent variable financial literacy and the dependent variable, profitability (Saunders et al., 2019; Creswell, 2014). The target population comprised 800 SMEs operating across retail, manufacturing, service, and wholesale sectors in Kiambu County (KNBS, 2023). Using Yamane's (1967) formula, a stratified random sampling technique was applied to select a representative sample of 80 SMEs, ensuring proportional representation across business categories.

1.7 Study Findings

The findings on the effect of financial literacy on profitability of small and medium enterprises in Kiambu county, Kenya are presented in this section.

Descriptive Statistics

Table 1: Descriptive Statistics for Financial Literacy and Profitability

The purpose was to examine the effect of financial literacy on profitability of small and medium-sized businesses in Kiambu county, Kenya.

Scale: 1 = Strongly Disagree 2 = Disagree 3 = Neutral 4 = Agree 5 = Strongly Agree

The findings on descriptive analysis of financial literacy are depicted in Table 1.

Statements	N	Mean	Std. Deviation
Financial literacy enhances SMEs' budgeting and savings practices.	73	3.26	1.344
Financial literacy improves SMEs' investment knowledge.	73	3.32	1.332
Financial literacy strengthens SMEs' knowledge of diversification strategies	73	3.11	1.439

Source: Field data, 2025

According to table 1 above, participants in the study agreed that financial literacy enhances investment knowledge (M = 3.32), strengthens understanding of diversification strategies (M = 3.11), and improves budgeting and savings practices (M = 3.26), thereby contributing significantly to SME profitability in Kiambu County. Respondents who had received financial training reported notable improvements in record keeping, debt management, expense control, savings, and profit tracking factors that collectively strengthened financial discipline and decision-making. Financial literacy also enabled SMEs to better manage risks, diversify income sources, and understand loan terms, fostering greater financial stability. However, some entrepreneurs experienced limited benefits due to unequal access to training opportunities. These findings align with previous studies indicating that financial literacy enhances SME profitability, risk resilience, and overall financial decision-making capacity (Owino et al., 2024; Musau et al., 2022).

Correlation Analysis

Table 2 below shows the correlation findings between financial literacy and profitability.

Table 2: Correlation Analysis

Correlations

		Financial Literacy	Profitability
Financial Literacy	Pearson Correlation	1	.812**
	Sig. (2-tailed)		.007
	Sig. (2-tailed)	.007	
	N	73	73

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Field data, 2025

At the 0.01 significance level ($p < 0.01$), the correlation coefficient ($r = 0.812$) shows a strong and statistically significant positive relationship between profitability and financial literacy. This indicates that as financial literacy rises, profitability rises significantly as well, proving that financially literate people or businesses are better able to make decisions that improve financial performance. Mwirichia (2023), who found that financial literacy has a positive impact on the performance of agro-processing companies in Nairobi County, supports these findings. Likewise, Gachiri (2024) discovered that increased financial literacy among Kilifi County's female entrepreneurs resulted in increased company profitability. Furthermore, Awino and Ombati (2024) highlighted that financial literacy initiatives boost commercial banks' profitability, while Owuor and Jagongo (2023) found that budgeting and bookkeeping literacy greatly improve the financial performance of SMEs. All of these studies support the idea that, in both individual and organizational settings, financial literacy is a key factor in determining profitability and long-term financial performance.

Regression Analysis

Table 3 below shows the regression findings between financial literacy and profitability.

Table 3: Regression Analysis

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.812[a]	.659	.648	.41257

a. Predictors: (Constant), Financial Literacy

b. Dependent: Profitability

Source: Field data, 2025

The correlation coefficient (R = 0.812) in the model summary demonstrates a strong positive relationship between profitability and financial literacy. This implies that there is a strong correlation between increases in profitability and improvements in financial literacy. The Adjusted R Square of 0.648 demonstrates that the model is still robust even after controlling for sample size and predictor adjustments, while the R Square value of 0.659 indicates that financial literacy accounts for roughly 65.9% of the variation in profitability. The model's predictions appear to be reasonably accurate and consistent, as indicated by the relatively low standard error of 0.41257. The significance of sound financial knowledge in improving organizational or individual financial performance is highlighted by these findings, which collectively show that financial literacy is a significant determinant of profitability. This conclusion is consistent with recent empirical research by Mwirichia (2023), who discovered that among Nairobi County's agro-processing businesses, financial literacy has a positive impact on firm performance. Gachiri (2024) and Awino and Ombati (2024) showed that increased financial literacy among bank customers and entrepreneurs results in improved financial performance and profitability, while Owuor and Jagongo (2023) found that budgeting and bookkeeping literacy significantly increase the profitability of SMEs. When taken as a whole, these studies demonstrate that financial literacy plays a critical role in determining profitability and long-term economic growth.

Discussion

The results of this study showed that among small and medium-sized businesses (SMEs) in Kiambu County, Kenya, financial literacy and profitability had a strong and statistically significant positive relationship. According to the descriptive findings, financial literacy improves SMEs' knowledge of investments, strengthens their grasp of diversification tactics, and improves their budgeting and saving practices. Compared to respondents who had not received financial management training, those who had showed superior record-keeping, debt management, expense control, and profit tracking abilities. With a Pearson correlation coefficient of $r = 0.812$ ($p < 0.01$), the correlation analysis validated this relationship, indicating that profitability rises in tandem with financial literacy. This conclusion was corroborated by the regression results, which showed that 65.9% of the variation in profitability among SMEs in the county can be explained by financial literacy (R Square value of 0.659). These results are in line with earlier research that highlights the critical role that financial literacy plays in enhancing the sustainability and performance of businesses. In Nairobi County, Mwirichia (2023) discovered that agro-processing companies' firm performance is greatly improved by financial literacy, while Owuor and Jagongo (2023) showed that SMEs' profitability is increased by budgeting and bookkeeping literacy. Similarly, Awino and Ombati (2024) found that financial literacy initiatives have a positive impact on commercial banks' profitability, and Gachiri (2024) found that women entrepreneurs with higher financial literacy levels have better business outcomes. When taken as a whole, these findings demonstrate that entrepreneurs who possess financial literacy are better equipped to manage resources, make wise investment choices, reduce financial risks, and increase overall business profitability.

1.8 Conclusion

According to the study's findings, Kiambu County's small and medium-sized businesses' profitability is significantly and favorably impacted by financial literacy. Higher financial literacy among SMEs is associated with more strategic financial decision-making, improved record-keeping, cost control, and effective use of financial resources, all of which contribute to increased sustainability and profitability. According to the results of the regression analysis, financial literacy is crucial for promoting business success and explains around 65.9% of the variation in profitability. These results highlight how critical it is to advance financial education as a means of boosting the expansion, competitiveness, and long-term economic stability of SMEs in the area.

1.9 Recommendations

The study suggests that in order to enhance budgeting, record keeping, debt management, and investment decision-making, Kiambu County's SME owners and managers ought to obtain additional financial literacy training. To guarantee long-term company growth and increased profitability among SMEs, the County Government of Kiambu should assume this duty in coordination with national government organizations, financial institutions, training facilities, and development partners. To integrate financial education into SME support programs and offer ongoing mentorship and advisory services, government organizations, financial institutions, and development partners should work together. In order to promote good financial management practices that eventually increase profitability and business sustainability, peer-to-peer learning initiatives should be supported, and digital platforms should be used to provide easily accessible financial literacy content.

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