FACTORS IN IMPROVING FINANCIAL MANAGEMENT PRACTICES FOR SUSTAINABLE GROWTH OF MICRO, SMALL AND MEDIUM ENTERPRISES IN ETHIOPIA

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Abstract

This study seeks to investigate how the practices of financial management improve the sustainable growth of micro, small, and medium enterprises (MSMEs) in Ethiopia. The study adopts a mixed-method approach, combining quantitative and qualitative research designs to gather and analyze the data. It focuses on MSMEs in three sub-cities of the capital, selecting a sample of 337 MSMEs using simple random and stratified sampling methods. The study used interviews and questionnaires to collect the data, examining key financial management aspects such as cash flow management practices, investment decision-making practices, and financial analysis and reporting, and inventory management practices. Both primary and secondary data were analyzed through inferential statistical and descriptive methods. The results indicate a significant positive relationship between financial management practices and the sustainable growth of MSME entrepreneurs. However, several critical challenges hinder MSME success, including inadequate record-keeping, limited financial literacy among managers and owners, and inefficient inventory and cash flow management practices. Furthermore, many business owners fail to leverage modern financial tools for informed investment decision-making. To enhance MSMEs' business understanding and skills of, the government should offer financial training programs, advisory services, mentorship and coaching opportunities, facilitate access to financing, and implement monitoring and evaluation systems. These initiatives can significantly contribute to their sustainable growth.

Keywords: *sustainable growth, financial management, MSMEs and Ethiopia*
JEL Code: *G32, L26, O16, M21, O55*

Introduction

Micro, small, and medium enterprises are widely recognized as a crucial component of economic growth and an essential strategy for countries emerging from poverty (Comfort et al., 2023). Recently, numerous countries have increasingly recognized the role of MSMEs in driving economic growth (Bayraktar–Algan, 2019). Research conducted by Oncioiu et al. (2018) in Romania indicates that Small and medium enterprises play a significant part in fostering a sustainable economy through their involvement in specific activities and the expansion of their investments. MSMEs are essential to economic growth and progress as they actively seek technological changes crucial for transforming the economy (Nkwinika–Akinola, 2023). Managing finance is a fundamental part of a company's operation, as it involves the planning and oversight of financial resources essential for the firm's safety and survival (Otoo, 2024; Kadam, 2012).

Effective and well-implemented financial management practices improve an enterprise's sustainable growth. However, they face challenges in raising finances, both externally and internally, whether through debt or equity (Chilembo, 2021). Good practices of financial management and reporting skills are vital for the health of MSMEs and to reinforce their social and economic support. But, many fail due to management problems (Widjanarko–Pramukty, 2022). According to a study by (Oliveira Saraiva et al., 2024), environmental factors, strategic approaches, and organizational structures impact the decline and growth of MSMEs. They also identify key factors affecting

MSMEs' sustainable development, such as raw materials, training access to finance, experience and education level. Furthermore, Micro, small and medium businesses usually struggle with financial problems. Specifically, not having a good understanding of how to manage their finances, along with uncertainty in the business environment, often causes these businesses to face serious challenges that affect their money situation and overall success (Karadag, 2015). According to a research study (Opoku–Okuampa, 2024), in Ghana, inadequate financial management is a significant factor contributing to the failure of many small businesses. As a result, if a micro-enterprise does not manage its finances well, it can hurt its ability to make profits.

Starting in 1992, the Ethiopian government implemented a series of economic reforms that led to significant growth in the private sector. As a result, the number of businesses, capital investment, and employment opportunities have expanded rapidly across the country. The number of private and limited companies skyrocketed, with the majority comprising micro, small, and medium enterprises (Debebe et al., 2023). MSMEs have become key drivers of Ethiopia's economy, contributing significantly to job creation, entrepreneurial development, and income generation for low-income individuals and households. They play a vital role in fostering economic growth, providing sustainable livelihoods, and enhancing the country's GDP (Weldeslassie et al., 2019). Even though they contribute substantially to the economy, MSMEs face numerous challenges that hinder their sustainable growth (OECD, 2023). These challenges include inadequate financial management practices or managerial skills, lack of trained personnel, and underutilization of new technologies for decision-making in investment and others (Dongming et al., 2023).

MSMEs are crucial role in advancing the development agenda of many developing countries, including Ethiopia (Endris–Kassegn, 2022; Lambert–Deyganto, 2023). Though Ethiopia is one of the fastest-growing economies in sub-Saharan Africa (Rohne Till, 2021), 60% of the MSMEs fail by the age of five years, resulting in bad economic situations like increasing unemployment, revenue loss and poor standard of living (Addisu, 2024; Andaregie–Astatkie, 2022). Usually, this is due to MSME owners' poor understanding of financial management for their business's sustainable growth (Kaban, 2024a; Ogheneogaga Irikefe – Isaac Opusunju, 2021). Moreover, MSMEs encounter numerous challenges that hinder their sustainable growth, including inadequate practices of financial management, reliance on manual record-keeping, inefficient inventory management, inadequate access to finance, insufficient infrastructure, and restricted market access (Akang Akaninyene Udo (Mnim), 2024; Debebe et al., 2023b).

Through comprehensive research efforts, this study intends to address these areas by identifying current gaps and delivering actionable insights that can enhance the capabilities of Ethiopian MSMEs, ultimately driving inclusive economic and sustainable growth throughout the country.

This study investigates how financial management practices improve the sustainable growth of MSMEs, specifically within the Addis Ababa city administration, the capital city known for its high concentration of such businesses. The study focuses on the aforementioned fundamental questions below to achieve this objective.

1. How effective are cash management practices in MSMEs in Ethiopia?
2. How do investment decision-making processes impact the sustainable growth of MSMEs in Ethiopia?
3. What role do financial reporting and analysis play in enhancing the sustainable growth of MSMEs in Ethiopia?
4. How efficient are inventory management techniques, and how do they influence financial performance and sustainable growth in MSMEs?
5. What are the key financial management challenges faced by MSMEs in Ethiopia, and what strategies can be proposed for improvement?

Literature Review

According to Ethiopia's National MSME Development Strategy (2019), the revised definition cited in Abate–Sheferaw (2023), enterprises are classified into three primary categories—micro, small, and medium enterprises. Their paid up capital and labor force determines this classification and further categorized into service and industry sectors, as shown in Table 1.

Table 1: Classification of Micro, Small and Medium Enterprises in Ethiopia

Enterprise Name	Sector	Number of employees	Capital paid in Ethiopian Birr
Micro	Industry	Less than or Equal to 5	Less than or equal to 100,000 Br.
	Service	Less than or Equal to 5	Less than or Equal to 50,000 Br.
Small	Industry	From 6 to 30	From 101,000 to 1,500,00 Br.
	Service	From 6 to 30	From 50,000 to 500,000
Medium	Industry	More than 30	More than 500,000
	Service	More than 30	More than 500,000

Source: (Abate–Sheferaw, 2023)

Sound financial management practices are crucial for sustainable business growth. They enable diversification and strategic planning, contributing to economic development (Dwyanti, 2024). On the contrary, poor financial management can lead to reduced profit margins and increased debt, negatively impacting a company's profitability and overall sustainable growth (Nyamwanza et al., 2020).

Researchers have long been interested in financial management practices within the MSME sector, focusing on various aspects depending on their specific objectives. For instance, some studies examine cash flow management, while others explore investment strategies or financial planning. This diversity reflects the complicated nature of financial management in MSMEs (Kaban, 2024b). The sustainable growth of small and medium enterprises (SMEs) are crucial role in driving the South African economy. However, their failure rate is among the highest in the world, reaching up to 90%. Research identifies a lack of financial management skills and practices as a significant factor contributing to SME failure. However, it remains unclear which specific skills and practices are most critical for the failure (Wolmarans–Meintjes, 2015). The study in Malawi, titled "Examining Barriers to SMEs' Access to Finance," found that the primary obstacles preventing small and medium enterprises from securing loans from traditional financial institutions are insufficient collateral, weak credit history, and excessively high interest rates (Banda-Nyirenda et al., 2024).

Numerous studies have shown that many MSME owners struggle with essential financial management skills, including budgeting, cash flow management, and financial reporting. Additionally, they often lack a comprehensive understanding of financial tools and technologies. For example, a study on SMEs in Masvingo, Zimbabwe, found that deficiencies in financial skills—such as budgeting, debt management, investment decision-making, and tax optimization significantly hinder business growth and long-term sustainability (Jongwe. et al., 2025). Additionally, research indicates that MSME owners often struggle with financial literacy, crucial for effective financial decision-making and business sustainability (Is et al., 2024).

A study conducted in Bangladesh by Amin (2024) about the challenges of financial management of small-scale enterprises revealed that most owners of small-scale businesses lack long-term financial planning, do not maintain proper records, and struggle with accounting due to limited knowledge. This poor financial management can lead to significant losses and threaten the sustainable growth of these businesses.

Conceptual Framework

According to Rocco–Plakhotnik (2009), a conceptual framework can be defined as a diagram showing the relationship between dependent and independent variables. In this study, the framework examined how financial management improves the sustainable growth of MSMEs. The dependent variable is micro, small and medium enterprise sustainable growth, while the independent variables include cash flow management, investment practices, and financial reporting and analysis, and inventory management practices. The independent and dependent variables are shown in Fig.1.

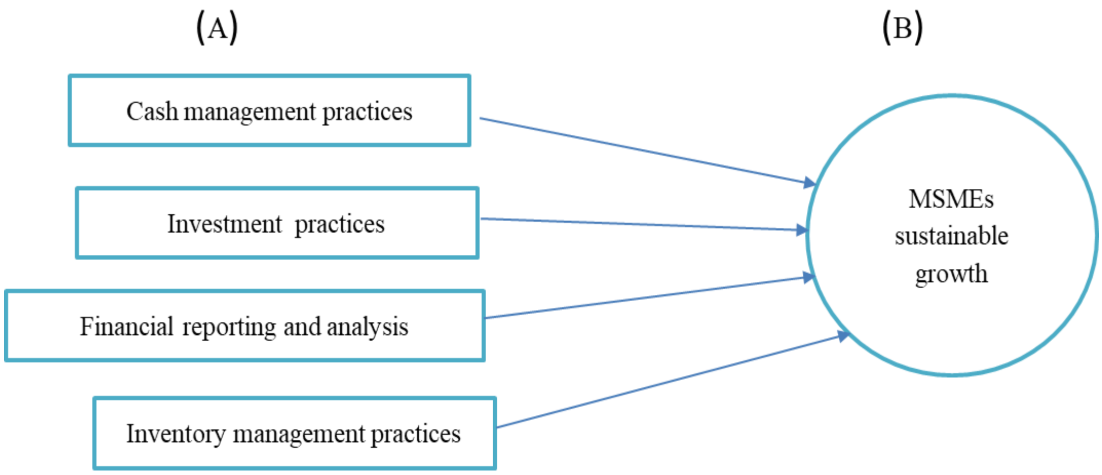

Fig.1 Independent variables (A) and dependent variable (B)

Material and method

The study employs a mixed-method approach, incorporating qualitative and quantitative research designs to collect and analyze data.

The study's objective is to investigate how the practices of financial management improve the sustainable growth of MSMEs in Ethiopia." Addis Ababa. Addis Ababa city has 11 sub-city administrations and 116 woreda-level administrations. This study focuses on three selected sub-cities: Addis Ketema, Bole, and Yeka. The sample includes businesses from various sectors within these sub-cities, with a higher concentration of micro, small and medium enterprise business owners compared to other sub-cities.

Data was collected through questionnaires from business owners, managers, and operators and face-to-face interviews. Additionally, secondary data sources, such as office manuals and reports, were utilized to enhance the findings.

The study used stratified and simple random sampling techniques to select a sample from the total population of active MSMEs in various sectors within the specified sub-cities. The population of these sectors in the year 2023/2024 included 538 service MSMEs, 1,223 construction MSMEs, 186 urban agriculture MSMEs, 354 manufacturing MSMEs, and 415 trade MSMEs, bringing the total to 2716 MSMEs as shown in Table 2. As mentioned below, the Proper sample size is selected based on Cochran's modified formula for a finite population (Cochran, 1977),.

$n = \frac{n_0}{1+\frac{(n_0-1)}{N}}$ Where, N is population, n= sample size, n_0=Cochran's determined sample

$$n = \frac{384}{1+\frac{(384-1)}{2716}}$$

$$n = 336.5421103566 \approx 337$$

Then, the sample size is 337.

Table 2: The sample size from the population proportionally

Sector	Population	Sample size
Service	538	67
Construction	1223	152
Urban agriculture	186	23
Manufacturing	354	44
Trade	415	51
Total	2,716	337

Source: Addis Ababa MSME office

Model Specification and Description of Variables

To investigate practices of financial management for improving the sustainable growth of MSMEs, an estimated equation is used, where MSME sustainable growth serves as the dependent variable**,** while cash flow management, investment, financial reporting and analysis, and inventory management practices **serve** as independent variables, as follows:

$$SGMSME = f\,(CMP, IP, FRAP, IMP) \quad (1)$$

It can be written using an econometric model with its functional forms.

$$SGMSMEs = \beta_0 + \beta_1 CMPt + \beta_2 IPt + \beta_3\, FRAPt + \beta_4\, IMPt + C \quad (2)$$

Whereas β0 is the intercept and β i (i = 1, 2, 3, 4.) represents the coefficient for each independent variable.

SGMSME = sustainable Growth of Micro, small and medium enterprises
CMP = cash management practices
IP = Investment practices
FRAP = Financial reporting and analysis
IMP = Inventory management practices

The data for this study were analyzed using descriptive statistics, including tables, frequencies, percentages, mean and standard deviation. Inferential statistics, such as Pearson's Product-Moment Correlation Coefficient and regression analyses, were used to investigate the relationships between the dependent and the independent variables. SPSS version 20 software was used to perform the data analysis.

Result and Interpretation

Descriptive Analysis

The descriptive analysis of the mean is interpreted in the following ways, as the researcher has adopted the Likert scale from other studies (Nee & Yunus, 2020), as shown in Table 3. Additionally, the percentage figures in the analysis combine strongly disagree and disagree into one group and strangely agree and agree into another for interpretation purposes.

Table 3: Four-point Likert scale mean range interpretation

Range Mean	Mode Response	Interpretation
3.26-4.00	Strongly agree	Very high
2.51-3.25	Agree	High
1.76-2.5	Disagree	Low
1.00-1.75	Strongly agree	Very low

Source: (Nee–Yunus, 2020)

MSME's financial reporting and analysis

This study revealed that most MSMEs' financial statements are prepared by employed or external accountants, with a low mean value of 1.6413, indicating limited involvement from managers/owners. Officials from the interview said that these statements are primarily reported for promotion to medium enterprises and tax purposes. Still, not all small and medium enterprises prepare the required income and financial position statements. Moreover, there is a lack of use of profitability ratios due to insufficient knowledge among accountants and managers, reflected in a low mean score of 1.9293. Similarly, liquidity (mean: 2.2120) and efficiency ratios (mean: 2.5272) were underutilized for assessing these business' the short-term liabilities and profitability as shown in Table 4.

Table 4: MSMEs' financial reporting and analysis

Items	Likert scale	Frequency	Per cent	Mean	Standard deviation
The manager/ owner is involved in preparing financial statements	Strongly disagree	200	59.3	1.6413	0.95907
	Disagree	95	28.2		
	Agree	5	1.5		
	Strongly agree	37	11		
	Total	337	100.0		
The business uses profitability ratios	Strongly disagree	158	46.9	1.9293	1.05603
	Disagree	88	26.1		
	Agree	49	14.5		
	Strongly agree	42	12.5		
	Total	337	100.0		
The business uses liquidity ratios	Strongly disagree	66	19.6	2.2120	.90153
	Disagree	176	52.2		
	Agree	53	15.7		
	Strongly agree	42	12.5		
	Total	337	100.0		

The business uses efficiency ratios	Strongly disagree	49	14.5	2.5272	1.04506
	Disagree	152	45.1		
	Agree	44	13.1		
	Strongly agree	92	27.3		
	Total	337	100.0		

Source: Own computation

MSMEs' sources of investment and financing items

Based on the responses from the questionnaire and supported by interviews, most MSMEs in Ethiopia do not utilize internally generated funds, with a mean score of 1.5109. Over 80% depend on government loans, but many struggle to obtain commercial bank loans due to collateral requirements, high interest rates, and poor record-keeping. Besides, MSMEs do not effectively manage their non-current assets (mean: 2.0598), negatively affecting their sustainable growth. Moreover, most MSMEs make investments without evaluating their viability using methods such as the net present value (NPV) method, resulting in a low mean NPV score of 1.7935. This lack of investment evaluation puts their initial capital at risk if investments fail, potentially impeding the future sustainable growth of this business, as shown in Table 5.

Table 5: MSMEs' sources of investment and financing items

Items	Likert scale	Frequency	Per cent	Mean	Standard deviation
The business has only generated cash sources	Strongly disagree	264	78.3	1.5109	1.05057
	Disagree	18	5.3		
	Agree	11	3.3		
	Strongly agree	44	13.1		
	Total	337	100.0		
The business has easy access to loans from commercial banks.	Strongly disagree	198	58.7	1.7065	1.03002
	Disagree	84	24.9		
	Agree	11	3.3		
	Strongly agree	44	13.1		
	Total	337	100.0		
The business fully utilizes the non-current investment	Strongly disagree	104	30.9	2.0598	1.00366
	Disagree	163	48.4		
	Agree	15	4.4		
	Strongly agree	55	16.3		
	Total	337	100.0		
The business uses net present value to assess the investment	Strongly disagree	189	56.1	1.7935	1.09682
	Disagree	84	24.9		
	Agree	9	2.7		
	Strongly agree	55	16.3		
	Total	337	100.0		

Source: Own computation

MSME Practices Cash flow Management in its business

MSMEs in Ethiopia, particularly in Addis Ababa, frequently face cash shortages, with 78.3% of respondents indicating that this hinders business operations. The reliance on government loans for nearly 80% of their financing contributes to these shortages, as much of the cash is used to cover liabilities. Many MSMEs prepare cash budgets but do not review them regularly, which worsens the problem. Most respondents reported not setting a minimum cash balance, and some were unaware of its significance. Additionally, 80.4% indicated that they do not invest temporary cash surpluses in marketable securities due to insufficient funds for investment. Furthermore, about 80.7% of respondents stated that their cash budgets are prepared manually rather than computer-assisted software (mean: 1.6630), leading to increased preparation time and burden for these enterprises, as shown in Table 6.

Table 6: MSME Practices Cash flow Management in its business

Items	Likert scale	Frequency	Per cent	Mean	Standard deviation
The business normally experiences a cash shortage	strongly disagree	13	3.9	3.3261	0.90062
	Disagree	60	17.8		
	Agree	68	20.1		
	Strongly agree	196	58.2		
	Total	337	100.0		
The business sets the minimum cash balance based on the owner's experience	strongly disagree	152	45.1	2.2609	1.33363
	Disagree	59	17.5		
	Agree	13	3.8		
	Strongly agree	113	33.6		
	Total	337	100.0		
A temporary cash surplus is invested in marketable securities	strongly disagree	194	57.6	1.7826	1.10465
	Disagree	77	22.8		
	Agree	11	3.3		
	Strongly agree	55	16.3		
	Total	337	100.0		
The business uses computer-assisted software to prepare a cash budget	strongly disagree	222	65.9	1.6630	1.05868
	Disagree	50	14.8		
	Agree	23	6.8		
	Strongly agree	42	12.5		
	Total	337	100.0		

Source: own computation

MSMEs Practice inventory on their own business

According to the respondents' feedback on periodic summary inventory, the study showed that most MSMEs in Addis Ababa do not prepare periodic inventory summaries, with over 58% failing to determine their inventory, which is essential for financial reporting, its absence leading to a poor understanding of inventory flow, and negatively affecting the sustainable growth of MEMEs. Additionally, about 72.7% of respondents do not use computer-assisted software for recording transactions (mean: 2.2228), indicating inadequate record-keeping, which further hinders effective inventory control, as shown in Table 7.

Table 7: MSMEs' Practice of inventory on their own business

Items Likert scale		Frequency	Per cent	Mean	Standard deviation
Periodic summaries of inventory usage and inventory counting are done as per the accounting periods.	strongly disagree	60	17.8	2.4457	1.01749
	Disagree	137	40.7		
	Agree	68	20.2		
	Strongly agree	72	21.3		
	Total	337	100.0		
The business uses computer-assisted software to record inventory	strongly disagree	71	21.1	2.2228	.96344
	Disagree	174	51.6		
	Agree	37	11		
	Strongly agree	55	16.3		
	Total	337	100.0		

Inferential results and analysis

The study used Pearson's Product Moment Correlation to assess the relationship between the independent and dependent variables, as shown in Table 8. Besides, regression analysis was conducted to determine how well the explanatory variables account for the variance in the dependent variable, as shown in Table 9.

Table 8: The relationship between independent and dependent variables

Independent variable	Relationship between dependent and independent variables	Sustainable Growth
Investment practices	Pearson Correlation	.895**
	Sig. (2-tailed)	.000
	N	337
Financial reporting and analysis practices	Pearson Correlation	.333**
	Sig. (2-tailed)	.000
	N	337
Cash management practices	Pearson Correlation	.234**
	Sig. (2-tailed)	.001
	N	337
Inventory management practices	Pearson Correlation	.908**
	Sig. (2-tailed)	.000
	N	337

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

Source: Own research

The results reveal that the correlation coefficients between MSME sustainable growth and its explanatory variables are increasing, varying from moderate to high. As presented in the Table 8, there is a high direct relationship correlation between investment practices and MSME sustainable growth ($r = .895$, $p < .01$), as well as between inventory management practices and sustainable growth and ($r = .908$, $p < .01$). Both correlations are highly significant at the 99% confidence level.

This indicates that investment practices and inventory management practices significantly influence the sustainable growth of MSMEs in the selected sub-cities of the capital city at a 1% significance level. . On the contrary, cash management practices (r = .234, p < .01) and financial reporting and analysis practices (r = .333, p < .01) showed weaker positive relationships with MSME sustainable growth. However, these relationships are also statistically significant at the 99% confidence level.

Table 9. Regress sustainable growth of MSME as outcome variable and others as explanatory variables using multiple regression

Model summary	R	R Square	Adjusted R Square
	.970[a]	.941	.940

		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
Coefficients	(Constant)	-.522	.088		-5.905	.000
	Financial reporting and analysis practices	-.356	.036	-.307	-9.792	.000
	investment practices	.709	.041	.580	17.338	.000
	cash flow management practices	.154	.042	.107	3.686	.000
	Inventory management practices	.619	.036	.550	17.022	.000

P < .01

Source: Own research

The results from the multiple regression analysis indicated a strong correlation of 0.970 between the observed sustainable growth value and the best combination of explanatory variables, which include financial reporting and analysis practices, investment practices, cash management practices, and inventory management. The R Square value is 0.941 while the adjusted R Square is 0.940, signifying that 94% of the difference in sustainable growth is attributed to these explanatory variables. Hence, only 6% remains unexplained. The unstandardized coefficients (column B) provide the coefficients for each explanatory variable within the regression equation as follows: Predicted sustainable growth score = -0.522 + (-0.356 * financial reporting and analysis practices) + (0.709 * investment practices) + (0.154 * cash management practices) + (0.619 * inventory management practices). All variables examined significantly account for variations in the outcome variable at a confidence level of 99%. The standardized beta-coefficient column reflects how much each variable contributes to predicting outcomes within this model; specifically, it shows that an increase by one standard deviation in investment practice has an average effect on MSE business sustainable growth represented by a beta weight of .580—the most significant influence among all predictors—followed closely by inventory management (.550), then cash management (.107). In contrast, financial reporting and analysis practice has a negative beta value of -.307, making it comparatively less effective as a predictor of sustainable business growth than other explanatory variables analyzed.

Conclusion and Recommendation

It is concluded that effective financial management practices significantly enhance the sustainable growth of MSMEs in Ethiopia. However, many challenges hamper their success, including poor record-keeping, limited financial literacy, and minimal involvement of managers and owners in preparing financial statements. Additionally, the lack of knowledge among accountants and managers leads to the underutilization of profitability ratios, essential for assessing short-term liabilities and overall profitability. Moreover, the majority of MSMEs face cash shortages due to dependence on government loans and the income is usually prearranged for payment of liabilities instead of reinvestment. In addition, most do not use internally generated funds, and many struggle to get commercial bank loans due to collateral requirements, high interest rates, and poor financial records. They also face difficulties in effectively managing non-current assets.

Furthermore, most MSMEs make investments without evaluating their viability using modern assessment criteria, such as the net present value method. Cash budgets are often prepared manually rather than computer-assisted software, and many MSMEs fail to prepare periodic inventory summaries. In addition, the lack of computer-assisted software for recording transactions contributes to inefficiencies in financial management.

The study finds that investment practices and inventory management strongly impact MSME sustainable growth, while cash management shows a weaker correlation. Regression analysis indicates that 94% of MSME growth is explained by investment practices (the strongest factor), followed by inventory and cash management, with financial reporting being the least influential factor.

To improve the sustainable growth of MSMEs in Ethiopia, financial literacy should be enhanced through training, and profitability ratios should be encouraged. MSMEs must use internally generated funds and improve their financial record-keeping to access bank loans. Effective management of non-current assets and modern investment evaluation methods like NPV should be adopted. Automating cash budgeting, preparing periodic inventory summaries, and using computer-assisted software for financial transactions will enhance efficiency. By implementing these measures, MSMEs can overcome economic challenges and achieve sustainable growth.

Limitations and future research

First, the scope of the study is limited to Addis Ababa, which may not represent the practices or the outcomes in other parts of the country. Second, the dependence on respondents' reported information creates the likelihood of biases, as respondents may have delivered usually desirable replies or may not have precisely revealed their characters. Lastly, the study's cross-sectional design limits the researcher's capability to draw causal implications, as it considers only a moment in time rather than investigating variations or causal relationships over a more extended period.

For future research, the study opens the door to longitudinal studies that would provide valuable insights into changes over time, enabling a better understanding of causal relationships and the long-term effects of the observed practices. Additionally, investigating the adoption and impact of digital financial tools on MSMEs could shed light on how technological advancements influence behavior and decision-making.

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