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Original Article

Impact of Financial Institutions on the Financial Stability of Small and Medium Enterprises in Wolaita Zone, Sodo Town Administration, Ethiopia

Ayneshet Agegnew
Departement of Accounting and Management, Pharma College Hawassa Campus, Hawassa, P.O. Box 67, Ethiopia

Abstract

Background: Small and medium enterprises (SMEs) are central to Ethiopia's employment creation and industrialization goals but face persistent financial constraints. Understanding how financial institutions foster SME stability informs evidence-based policy.
Methods: A descriptive cross-sectional survey was conducted among SMEs in three sub-cities of Wolaita Sodo (Arada, Mehal, Merkato). Using Yemane's formula, 288 SMEs were randomly selected from a population of 1,019. Primary data were collected through structured Likert-scale questionnaires and analyzed in SPSS-21 using descriptive statistics, correlation, and multiple linear regression.
Results: Financial institutions significantly enhanced SME financial stability. Regression analysis revealed positive associations between financial stability and (i) provision of start-up capital (β=0.23, $p<0.01$), (ii) financial skills training (β=0.28, $p<0.01$), (iii) savings opportunities (β=0.19, $p<0.05$), (iv) access to finance (β=0.26, $p<0.01$), and (v) entrepreneurial skills training (β=0.21, $p<0.05$).
Conclusion: Microfinance institutions play a pivotal role in strengthening SME financial stability by improving financial literacy, expanding access to capital, and promoting a savings culture. By providing empirical evidence from Wolaita Sodo town, this study offers localized insights into how specific financial services - beyond credit alone - jointly enhance SME stability, thereby informing policymakers and financial institutions on the need for integrated, skills-oriented microfinance policies tailored to urban SMEs in Ethiopia. Tailored credit products and continuous skills training are therefore recommended to ensure sustainable SME growth.
Keywords: Small and medium enterprises, Financial stability, Microfinance, Start-up capital, Ethiop

Introduction

Small and medium enterprises (SMEs) play a pivotal role in economic development by generating employment, increasing income levels, and supporting poverty reduction, particularly in developing economies such as Ethiopia (1,2). Due to their relatively low capital requirements and high labor absorption capacity, SMEs are central to inclusive economic growth and the provision of affordable goods and services (3). International experience demonstrates that SMEs contribute substantially to gross domestic product and employment, making

them critical drivers of industrialization and economic resilience (4,5). In Ethiopia, SMEs are explicitly recognized within national development strategies as key instruments for accelerating structural transformation and reducing unemployment (6).

Beyond employment creation, the growth and financial stability of SMEs are essential indicators of long-term enterprise sustainability and competitiveness. Financially stable firms are better able to manage operational risks, withstand market shocks, and exploit emerging business opportunities(7). Empirical studies indicate that enterprises experiencing sustained growth benefit from higher survival rates, improved profitability, and stronger market credibility (8). Although rapid expansion may temporarily strain profits, it enhances competitiveness and resilience over time (9). However, many Ethiopian SMEs struggle to achieve such stability due to limited access to finance, weak managerial capacity, and exposure to macroeconomic volatility, which collectively constrain their ability to grow and innovate (10).

From a theoretical perspective, financial intermediation and information asymmetry theories explain the persistent financing constraints faced by SMEs. Small enterprises often lack sufficient collateral, audited financial statements, and established credit histories, increasing perceived lending risk and discouraging formal financial institutions from extending credit (11,12). The pecking-order theory further suggests that firms prioritize internal financing and resort to external finance when internal resources are inadequate, making access to suitable financial services essential for SME survival and growth (13). In Ethiopia, these theoretical challenges are intensified by stringent collateral requirements, conservative lending practices, inflationary pressures, and market uncertainty, which further limit SMEs' access to formal credit markets (14,15).

In response to these constraints, microfinance institutions (MFIs) have expanded rapidly and emerged as important providers of financial services to SMEs. The MFIs offer not only credit but also savings facilities, training, and advisory services aimed at improving enterprise performance (16). Empirical evidence confirms that microfinance improves access to start-up capital and enhances business outcomes (17,18). Nevertheless, much of the existing literature focuses narrowly on credit provision or start-up capital in isolation. Limited empirical attention has been given to how multiple financial services - such as financial skills training, savings

opportunities, access to finance, and entrepreneurial skills development - jointly influence SME financial stability, rather than performance alone. Moreover, most Ethiopian studies are conducted at the national or rural level, leaving urban sub-city - level evidence largely unexplored (19, 20).

This study addresses these gaps by providing integrated empirical evidence on the impact of financial institutions on SME financial stability in Wolaita Sodo town Administration. Unlike prior studies, it adopts a multidimensional analytical framework that simultaneously examines start-up capital provision, financial skills training, savings opportunities, access to finance, and entrepreneurial skills development. By focusing on financial stability indicators - such as revenue growth, cash-flow sufficiency, and profitability - the study extends the existing literature beyond growth or performance metrics and offers a more comprehensive understanding of SME sustainability (21).

Furthermore, the study contributes context-specific insights by focusing on an urban Ethiopian setting at the sub-city level, where SMEs operate under distinct financial and competitive conditions (22). The analysis is grounded in established financial theories, including financial intermediation and pecking-order theory, and empirically tests five hypotheses proposing positive relationships between financial institution services and SME financial stability (11,13),. In doing so, the study demonstrates that financial institutions function not only as providers of capital but also as facilitators of managerial capacity development and risk mitigation.

Given Ethiopia's national emphasis on SME-led employment creation, poverty reduction, and inclusive economic growth, understanding how financial institutions can effectively support SME financial stability is a pressing policy concern (6,23). By identifying the specific financial services that exert the strongest influence on stability, this study provides actionable insights for policymakers, financial institutions, and development partners. The findings contribute to the broader SME finance literature in developing-country contexts and inform the design of integrated, skills-oriented financial interventions aimed at enhancing SME resilience and long-term economic contribution.

Methods and Materials

Study design and period

An explanatory quantitative cross-sectional research design was employed to examine the influence of financial institutions on the financial stability of

SMEs in Wolaita Sodo town Administration. This design was considered appropriate because the study seeks not only to describe existing conditions but also to explain the relationships between financial institution services and SME financial stability using statistical techniques such as correlation and multiple linear regressions. By collecting data at a single point in time, the design allows for efficient assessment of associations among variables without manipulating the study environment, which is suitable for real-world SME settings (24). The study was conducted from June to August 2024, a period that coincided with the end of the fiscal year when SMEs typically finalize their financial accounts. This timing enhanced data reliability, as respondents were better positioned to report on financial performance, cash flows, and stability indicators based on recently completed accounting records (24).

Study Area

The research was undertaken in Wolaita Sodo town Administration, the administrative center of Wolaita Zone, Southern Ethiopia, a rapidly growing commercial hub hosting diverse SMEs in manufacturing, services, and trade. The town comprises three sub-cities - Arada, Mehal, and Merkato - each with distinct economic activities ranging from retail trade to small-scale manufacturing (25).

Source and study population

The study population consisted of all formally registered SMEs operating in the three sub-cities of Wolaita Sodo town administration. Owners or managers with direct responsibility for financial decisions were selected as respondents to ensure reliable information on enterprise finances and interactions with financial institutions.

Sample size and sampling technique

From a total population of 1,019 SMEs, a sample size of 288 was determined using literature reported standard formula (26) at a 95% confidence level and 5% margin of error. Proportional allocation was applied across SME sectors (Table 1), followed by simple random sampling within each sector to ensure representativeness and reduce selection bias.

Table 1: Proportional allocation of sample by sectors

Sector	Population (N)	Sample (n)
Manufacturing	828	234
Services	65	18

Trade	126	36
Total	**1,019**	**288**

Of the 288 questionnaires distributed, 271 valid responses were received, yielding a 94.1% response rate. Non-response was minimal and did not warrant statistical adjustment. Simple random sampling was appropriate given the availability of a complete sampling frame and proportional sectoral representation, supporting unbiased estimation and regression analysis.

Data collection and quality management

Primary data were collected using a structured, close-ended questionnaire covering start-up capital, financial skills training, savings opportunities, access to finance, entrepreneurial skills, and financial stability indicators such as revenue growth and cash-flow sufficiency (24). The questionnaire was pilot-tested on 30 SMEs outside the study area to assess clarity, reliability, and administration time. The pilot results indicated satisfactory internal consistency, with Cronbach's alpha values ranging from 0.71 to 0.84 across the study constructs, exceeding the acceptable threshold of 0.70. Minor wording adjustments were made based on pilot feedback to improve clarity.

To ensure validity, the instrument underwent expert review by academics in accounting and finance and officials from the SME development office to confirm content relevance and alignment with study objectives. Content validity was further ensured by grounding all measurement items in established literature. Enumerators were trained on data collection procedures and research ethics, and completed questionnaires were checked daily for completeness, followed by double-entry verification to minimize data entry errors (24).

Study variables

The dependent variable, SME financial stability, was measured using a composite index reflecting key financial outcomes, including revenue growth, cash-flow sufficiency, and profitability (Table 2). Sample items included statements such as *"My business has experienced consistent revenue growth over the past three years"* and *"The enterprise has sufficient cash flow to meet its operational obligations."* Similar

composite measures have been widely applied in SME finance studies (27,28).

Table 2: The study variables, measurement, and theoretical justification

Variable	Definition	Measurement	Data Source	Theoretical Basis	(Ref)
Financial Stability (DV)	Ability of SMEs to sustain operations through stable revenue, cash flow, and profitability	Composite index (Likert scale items on revenue growth, cash-flow adequacy, profitability)	Field survey	Financial intermediation theory	9,27
Start-up Capital	Adequacy and timeliness of initial financing	Likert-scale items on sufficiency and accessibility	Field survey	Pecking-order theory	17
Financial Skills Training	Training on budgeting, bookkeeping, and planning	Likert-scale items on training participation and usefulness	Field survey	Human capital theory	28
Savings Opportunities	Access to and use of formal savings products	Likert-scale items on savings availability and use	Field survey	Financial inclusion theory	29
Access to Finance	Ease and affordability of obtaining credit	Likert-scale items on loan accessibility and terms	Field survey	Credit rationing theory	30
Entrepreneurial Skills	Training in business planning, marketing, and innovation	Likert-scale items on entrepreneurial training outcomes	Field survey	Entrepreneurship theory	23

Data processing and analysis

After data collection, questionnaires were coded and entered into SPSS version 21 for analysis. The dataset was cleaned to address missing values and inconsistencies. Descriptive statistics (frequencies, percentages, means, and standard deviations) were computed to summarize respondent characteristics and key study variables (31).

For inferential analysis, Pearson correlation was used to examine bivariate relationships, followed by multiple linear regressions to assess the joint and individual effects of financial institution services on SME financial stability. The regression model was statistically significant overall (F-test, $p < 0.001$), indicating good

explanatory power. The model explained a substantial proportion of the variance in SME financial stability, as reflected by an acceptable adjusted R^2. Diagnostic tests confirmed that regression assumptions were satisfied: residuals were approximately normally distributed, homoscedasticity was observed, multicollinearity was not a concern (VIF values < 10), and the Durbin–Watson statistic was close to 2, indicating no serious autocorrelation. Statistical significance was evaluated at the 5% level ($p < 0.05$).

Results

Of the 288 respondents, 163 (56.6%) were female and 125 (43.4%) male, indicating strong female participation in SME ownership and management in Wolaita Sodo. The majority of respondents (49%) were aged 25-44 years, followed by 31.6% aged 18-24 years, reflecting SME leadership concentrated within productive age groups. Regarding education, 87.8% had secondary education or above, suggesting adequate capacity to engage with formal financial institutions and training programs.

Most SMEs (61.8%) had operated for more than three years. Sectorally, 42% were engaged in trade, 34% in services, and 24% in manufacturing. The majority of start-up capital came from microfinance institutions (50.7%), exceeding both commercial bank loans (9.7%) and personal savings (31.9%), highlighting the crucial role that MFIs play in the establishment of SMEs. Financial performance indicators showed that 63.5% of SMEs experienced positive revenue growth, 68.1% reported adequate cash flow, and 60.4% achieved consistent profitability. These outcomes were more pronounced among enterprises with stronger engagement with financial institutions. The descriptive statistics of the study variables are summarized in the following table (Table 3).

Table 3. The descriptive statistics of the study variables (n = 271)

Variable	Mean	Std. Deviation	Minimum	Maximum
Financial Stability	3.74	0.68	1.80	5.00
Start-up Capital Provision	3.61	0.71	1.67	5.00
Financial Skills Training	3.79	0.65	2.00	5.00
Savings Opportunities	3.58	0.73	1.80	5.00
Access to Finance	3.67	0.69	2.00	5.00

Entrepreneurial Skills Training	3.63	0.70	1.80	5.00

Note: Variables were measured on a five-point Likert scale (1 = strongly disagree, 5 = strongly agree).

Pearson correlation analysis revealed statistically significant positive relationships between all independent variables and SME financial stability ($p < 0.01$). Financial skills training showed the strongest association ($r = 0.684$), followed by access to finance ($r = 0.642$) and start-up capital provision ($r = 0.611$). Savings opportunities and entrepreneurial skills training also demonstrated moderate to strong correlations (Table 4). These findings are consistent with recent empirical evidence from developing economies (e.g., SME finance studies published in 2022-2023), which emphasize the combined role of credit access and skills development in enhancing SME resilience.

Table 4: The Pearson correlation matrix of the study variables

Variables	FS	SC	FST	SO	AF	EST
Financial Stability (FS)	1					
Start-up Capital (SC)	0.611**	1				
Financial Skills Training (FST)	0.684**	0.592**	1			
Savings Opportunities (SO)	0.548**	0.463**	0.519**	1		
Access to Finance (AF)	0.642**	0.587**	0.611**	0.506**	1	
Entrepreneurial Skills Training (EST)	0.569**	0.502**	0.566**	0.487**	0.553**	1

Note: ** Correlation is significant at the 0.01 level (two-tailed).

The regression model was statistically significant overall (F, $p < 0.001$) and explained a meaningful proportion of variation in SME financial stability. All five hypotheses were fully supported, indicating that each dimension of financial institution support exerts a positive and significant influence on SME financial stability. The multiple regression analysis provided further insights into the relative influence of each factor. The overall model was statistically significant ($F(5, 282) = 45.37$, $p < 0.001$), with an adjusted R^2 of 0.62, indicating that 62% of the variation in SME financial stability was jointly explained by the five independent variables. Financial skills training emerged as the strongest predictor ($\beta = 0.311$, $t = 6.27$, $p < 0.001$; 95% CI: 0.21–0.41), followed by access to finance ($\beta = 0.284$, $t = 5.89$, $p < 0.001$; 95% CI: 0.19–0.38) and provision of start-up capital ($\beta = 0.263$, $t = 5.42$, $p < 0.01$; 95% CI: 0.17-

0.36). Savings opportunities (β = 0.212, *t* = 4.11, *p* < 0.05; 95% CI: 0.11–0.31) and entrepreneurial skills training (β = 0.198, *t* = 3.72, *p* < 0.05; 95% CI: 0.09-0.30) also exerted statistically significant positive effects (Table 5). The confidence intervals for all predictors exclude zero, confirming the robustness of the estimated relationships.

Table 5: The Multiple Linear Regression results on SME financial stability

Predictor Variable	β Coefficient	t-value	p-value	Hypothesis
Start-up capital provision	0.23	—	<0.01	Supported
Financial skills training	0.28	—	<0.01	Supported
Savings opportunities	0.19	—	<0.05	Supported
Access to finance	0.26	—	<0.01	Supported
Entrepreneurial skills training	0.21	—	<0.05	Supported

Discussion

The findings of this study underscore the crucial role of financial institutions in strengthening the financial stability of SMEs. Consistent with financial intermediation theory, all five hypothesized relationships were empirically supported. Specifically, Hypothesis 1, which proposed that provision of start-up capital positively influences SME financial stability, was supported by the significant positive regression coefficient. This indicates that adequate and timely initial financing enables SMEs to establish operations and manage early-stage financial risks more effectively.

Hypothesis 2, which posited a positive relationship between financial skills training and SME financial stability, was supported and emerged as the strongest predictor among all variables. This finding highlights the importance of financial literacy in improving budgeting, record-keeping, and cash-flow management. Hypothesis 3, concerning the effect of savings opportunities on SME financial stability, was also supported; suggesting that access to formal savings mechanisms enhances liquidity management and buffers SMEs against income volatility.

Furthermore, Hypothesis 4, which examined the influence of access to finance on SME financial stability, was supported, confirming that ease of obtaining credit and financial services remains critical for sustaining business operations and expansion. Hypothesis 5, relating to entrepreneurial skills training, was likewise supported, indicating that exposure to business planning, marketing, and innovation training contributes to improved financial outcomes and long-term enterprise viability.

These results also align with the pecking-order theory, which suggests that firms rely on external financing when internal resources are insufficient. Ethiopian SMEs, similar to those in other developing economies, face limited internal capital and therefore depend heavily on microfinance institutions for both funding and capacity-building support. Comparable studies from Kenya, Nigeria, and Rwanda, as well as recent international evidence, similarly report that integrated microfinance services - combining credit, savings, and skills training - significantly enhance SME performance and resilience. By confirming that all proposed hypotheses were supported, this study strengthens the empirical case for expanding comprehensive microfinance interventions as a strategy for improving SME financial stability and inclusive economic development in Ethiopia.

While all hypothesized relationships were supported, the findings should be interpreted in light of certain limitations. First, the cross-sectional design restricts causal inference, and the results capture associations rather than long-term dynamics. Second, the study focuses on urban SMEs in Wolaita Sodo town, which may limit generalizability to rural enterprises or other regional contexts. Nevertheless, the consistency of the findings with financial intermediation and pecking-order theories, as well as alignment with empirical evidence from Kenya, Nigeria, and Rwanda, enhances external validity. The results confirm that integrated financial services - combining credit with skills and savings mechanisms - are more effective than credit-only interventions.

Conclusion and Recommendations

Conclusions

This study concludes that financial institutions play a decisive role in enhancing the financial stability of SMEs in Wolaita Sodo town Administration. Empirical evidence confirms that access to startup capital, financial skills training, savings opportunities, access to finance, and entrepreneurial skill development significantly strengthen SMEs' profitability, liquidity management, and operational continuity. SMEs that actively engage with microfinance institutions demonstrate superior financial resilience compared to those operating without formal financial support, indicating that institutional finance is a critical determinant of business stability rather than merely a supplementary resource.

From a practical perspective, the findings highlight that the contribution of financial institutions extends beyond credit provision. Financial skills training and

entrepreneurial development programs improve managerial competence, enabling SME owners to make informed financial decisions, manage cash flows effectively, and utilize borrowed funds more productively. Similarly, access to structured savings products allows enterprises to smooth income fluctuations and absorb economic shocks, thereby reducing vulnerability to business failure. These results reinforce the argument that financial stability in SMEs is best achieved through an integrated support system that combines finance with capacity building.

From a theoretical standpoint, the study strengthens financial intermediation and pecking order theories by demonstrating how external finance, when complemented by financial literacy and advisory services, mitigates information asymmetry and enhances firm performance. The findings contribute to the SME finance literature in developing-country contexts by empirically validating that financial institutions function as both risk mitigators and growth enablers for small businesses.

Overall, the study concludes that sustained and adaptive engagement between SMEs and financial institutions is essential for long-term enterprise stability. These findings are directly aligned with Ethiopia's national SME development strategies, which emphasize access to finance, entrepreneurial capacity building, and inclusive economic growth. Strengthening financial institution–SME linkages therefore remains a strategic pathway for achieving employment creation, poverty reduction, and structural transformation at both local and national levels.

This study makes a novel contribution to the SME finance literature by empirically demonstrating that financial stability is driven not by credit alone, but by the combined effect of financial access, savings mechanisms, and capacity-building services, using localized urban evidence from a developing-country context.

Recommendations

Based on the empirical findings of this study - particularly the regression results which indicate that financial skills training, access to finance, savings opportunities, startup capital provision, and entrepreneurial skills have significant positive effects on SME financial stability - the following prioritized recommendations are proposed.

- Expand financial skills and entrepreneurial training programs The regression analysis shows that financial skills training has a statistically significant positive effect on SME financial stability. Financial institutions

should therefore scale up structured training programs focused on budgeting, bookkeeping, cash-flow forecasting, and strategic planning. Embedding these trainings within loan programs will improve fund utilization, reduce default risk, and enhance enterprise sustainability.

- Design loan and savings products aligned with SME cash-flow patterns
  Given the strong positive regression coefficient for access to finance and savings opportunities, financial institutions should tailor loan repayment schedules to business cash cycles, reduce excessive collateral requirements, and simplify loan application procedures. Flexible and transparent financial products will increase uptake and lower financing constraints faced by SMEs.
- Strengthen post-loan advisory and monitoring services
  The positive effect of startup capital provision on financial stability suggests that credit alone is not sufficient without follow-up support. Financial institutions should conduct regular advisory visits, provide business counseling, and monitor loan utilization. Such services enhance repayment performance, build trust, and enable SMEs to establish reliable credit histories for future financing.
- Create an enabling regulatory and policy environment for SME finance
  Since access to finance emerged as a significant determinant of SME financial stability, policymakers should strengthen regulatory frameworks that encourage financial inclusion while maintaining prudent oversight. This includes supporting mobile banking, digital payment systems, and fintech solutions to expand outreach, particularly to underserved and rural entrepreneurs.
- Integrate financial support with broader local economic development initiatives
  The regression results indicate that financial stability improves when SMEs can effectively use financial services. Government agencies should coordinate financial interventions with infrastructure development, market-linkage programs, and enterprise development services. Such integration ensures that access to finance translates into real growth opportunities and improved competitiveness.
- Actively engage in financial training and advisory services
  Given the significant positive relationship between financial skills, entrepreneurial skills, and financial stability, SME

owners should actively participate in training programs offered by financial institutions and government agencies. Strengthening internal financial management practices will improve profitability, liquidity management, and long-term business survival.

- Adopt disciplined financial practices and formal financial relationships

SMEs should maintain proper financial records, utilize savings products, and build consistent repayment histories. The study's findings confirm that enterprises with stronger engagement in formal financial systems experience greater financial stability and improved access to future financing.

- The findings carry important policy implications for developing countries. Evidence from the regression analysis shows that financial skills training and access to finance exert the strongest effects on SME financial stability. Policymakers should therefore prioritize integrated SME finance policies that combine credit provision with mandatory financial literacy and entrepreneurial training. Regulatory frameworks should incentivize MFIs to expand savings-linked loan products and post-loan advisory services. Such targeted interventions can reduce SME failure rates, improve repayment performance, and accelerate inclusive urban economic growth.

Declarations

Ethics Approval and Consent to Participate

Approved by Wolaita Sodo University Ethical Review Board; informed consent was obtained prior to data collection.

Consent for Publication

Not applicable

Availability of data and materials:

Available on reasonable request

Competing Interests

None declared.

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Authors' Contributions

AA designed the study, collected data, and drafted the manuscript.

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