

## **Financial Literacy: How It Determines the Performance of Micro, Small, and Medium Enterprises**

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### **ABSTRACT**

The capability of business entrepreneurs to run a business will determine the high and low performance of the company. Understanding financial concepts and management skills will assist business entrepreneurs in managing cash flow. The study aims to analyze the Micro, Small, and Medium Enterprises (MSMEs) entrepreneurs' financial literacy and the impact on performance. This research also focuses on entrepreneurs' cash flow management as a form of financial behavior. Data were obtained from MSMEs' owners or managers in West Java, Indonesia. Data were processed using Structural Equation Modeling, and the results show that financial literacy determines financial behavior regarding cash flow management. It also indicates that cash flow management behavior has a role in determining the MSMEs' performance. The study contributes to the finance literature, especially related to MSMEs, emphasizing the impact of financial literacy in determining MSMEs' performance through cash flow management.

**Keywords:** Financial Knowledge; Financial Behavior; Cash Flow Management; Performance.

### **1. INTRODUCTION**

Domestic and international financial transactions require financial knowledge and skills (Susan M. , The antecedents of financial literacy: a study on college students, 2020a). Although financial literacy is related to education level (Fan & Chatterjee, 2018)(Anshika, Singla, & Mallik, 2021) (Corsini & Gianelli, 2021), education can bridge the financial literacy gap (Adam, 2017), and the difference in education creates a financial knowledge gap (Amagir, Groot, Brink, & Wilschut, 2020), previous studies show that even college students as part of an educated society do not have sufficient financial knowledge (Ibrahim & Alqaydi, 2013). Similar problems also occur in most Indonesian people. Financial literacy issues still become problems for most Indonesian people and are considered a national issue. The financial literacy index shows that many Indonesians lack financial literacy (OJK, 2019). Although one study on students who received education showed that they had above-average financial management knowledge (Susan & Djajadikerta, 2017), students who had taken financial management subjects should have higher financial knowledge than their current level (Susan M. , 2018).

In the context of MSMEs, the lack of financial literacy aligns with the previous results. Financial literacy research conducted on MSMEs entrepreneurs in West Java, Indonesia, shows that some MSMEs owners or managers have not recognized the importance of having insurance to protect company assets as a consideration regarding financial decisions (Susan M. , 2020b). Besides the lack of business management knowledge, MSMEs owners also often do not attend business training that can enhance their knowledge and business skills (Osinde, Iravo, Munene, & Omaiyo, 2013). MSMEs entrepreneurs need financial knowledge in running their business related to various decisions related to financial aspects, including the need for a financial statement concerning financing requirements (Dahmen & Rodriguez, 2014). It is an important thing that needs to be a concern for MSMEs, considering that financial knowledge affects performance positively, and higher financial knowledge results in higher savings and margins (Cherotich, Ayuya, & Sibiko, 2019).

Financial knowledge is a factor that predicts financial management, which can be measured using cash management as one of the measurement methods (Parrotta & Johnson, 1998). Financial literacy is also associated with behavior related to decisions regarding loans (Liu & Zhang, 2021), in which MSMEs face the issues and challenges in acquiring loans (Lim, Aquino, Garcia, Ong, & Soliman, 2020). In this case, poor cash management can cause MSMEs to experience difficulties in paying debts. It can hinder the company's operating activities which in turn will be able to affect business performance and growth (Kakeeto, Timbirimu, Kiizah, & Osunsan, 2017). This study aims to obtain empirical evidence regarding the determination of financial literacy on the performance of MSMEs. The study also analyzes the business entrepreneurs' behavior related to cash flow management and its impact on MSMEs' performance.

## **2. THEORETICAL FRAMEWORK AND HYPOTHESES**

Personal financial management requires discipline in managing finance. Financial knowledge and the capability to manage money are critical factors in making the right financial decisions and managing finance well (Anthony & Sabri, 2015) (Gitman & Zutter, 2015). Understanding individual financial decision-making and analysis can help them understand the consequences of each financial decision (Gitman & Zutter, 2015).

Financial literacy enables individuals to make financial plans and manage and control finances (Mu'izzuddin, Ghasarma, Putri, & Adam, 2017). Someone with higher financial literacy will have higher confidence in making financial decisions (Arifin & Soleha, 2019). Therefore, financial literacy can improve individuals' living standards by planning and preparing finances for future targets. (Hossain & Maji, 2021). The terms financial knowledge and financial literacy are often used interchangeably (Bir, 2014). Some studies use the concept and the term financial literacy the same as actual financial knowledge (Ramalho & Forte, 2019).

There is a relationship between financial knowledge and financial behavior, encompassing cash flow management, credit management, saving, and investment practices (Hilgert, Hogarth, & Beverly, 2003) (Robb & Woodyard, 2011). Increased financial knowledge does not always lead to recommended financial behavior (Hilgert, Hogarth, & Beverly, 2003). However, past studies shows that financial knowledge can determine financial behavior (Robb & Woodyard, 2011), and the result of the study indicates that individuals who possess financial knowledge would commonly show

recommended financial behavior. They would pay their loans on time, reconcile their financial statement, and has cash for precautionary (Hilgert, Hogarth, & Beverly, 2003).

Cash flow management is a business skill required by business owners or managers due to its positive relationship with business performance. Cash management variation is capable of varying business growth (Eton, Godfrey, Nyangoma, & Mwosi, 2019). The size and risk of cash flow are essential aspects that determine the value of a company. A company needs to plan and manage cash flow to obtain a positive cash flow for shareholders and ensure the company can pay all its liabilities. With a focus on cash flow, a company can pay debts and also achieve its financial goals. Specific for individuals, they tend to use cash flow over a given period in planning, monitoring, and assessing their financial activities (Gitman & Zutter, 2015).

Owners and managers of the MSMEs need to use a more systematic financial management approach following the growth and complexity of their business. With higher financial literacy, MSMEs owners and managers can control their business' financial performance (Mazzarol, Reboud, & Clark, 2015). Related to the investment study, past research reveals a strong effect of financial literacy on investment behavior (Mouna & Anis, 2017).

Based on the theoretical framework which explains the relationship between the three variables, the research hypotheses are:

H1: Financial literacy has a positive impact on the cash flow management of the MSMEs

H2: Cash flow management has a positive impact on the MSMEs performance

H3: Financial literacy has a positive impact on the MSMEs performance

### **3. METHODS**

This research uses a survey design with a sample of MSME entrepreneurs in West Java, Indonesia. The units of analysis in the study are owners or managers of MSMEs in West Java, Indonesia with as many as 210 respondents. Collected data from MSMEs entrepreneurs are primary data regarding three research variables: financial literacy, cash flow management, and MSME performance. In this case, financial literacy is the independent variable, MSME performance is the dependent variable, and cash flow management is the intervening variable.

The instrument used a numerical scale with a 6-point scale to measure each indicator of all variables. Instrument testing went through validity and reliability tests to ensure the usability of the measuring instrument. The study is verificative research designed to examine the interrelationship between research variables, and the confirmation of said relationship was conducted using SEM. The relationship between the variables is confirmed using Structural Equation Modeling.

### **4. RESULTS AND DISCUSSION**

From the data collection process by distributing questionnaires to MSMEs' owners or managers, 210 data were collected. The validity and reliability tests were conducted first to ensure that all item measures all latent variables and that the instruments used are reliable. Construct reliability and validity were assessed for financial literacy, cash flow

management, and performance. Reliability was tested using the Cronbach alpha value. Table 1, which shows the reliability test result for each construct, verifies that the scale items consistently reflect the measured construct. The results show that the alpha value for all constructs is higher than 0.70, suggesting the measures' high internal consistency (Hair, Black, Babin, & Anderson, 2019). It indicates that the items used to measure the constructs are reliable and satisfactory. Regarding the validity testing, the results show that the item-to-total correlation value of each item is between 0.388 - 0.827. The testing result was collected after discarding an item from the financial literacy construct invalid during the initial testing.

Table 1 Reliability Test Results

<b>Variables</b>	<b>Values</b>
Financial Literacy	0.813
Cash Flow Management	0.885
Performance	0.787

Structural equation modeling was conducted to test the hypotheses in the study and determine the causal relationship between financial literacy, cash flow management, and performance. Figure 1 shows the results of the structural model from the data processing. The result specifies the causal relationships among constructs. The goodness of fit indices (GFI) = 0.87, Adjusted Goodness of Fit Index (AGFI) = 0.82, Normed Fit Index (NFI) = 0.91, and Comparative Fit Index (CFI) = 0.94. As Table 2 shows, the structural coefficient for financial literacy was positive and statistically significant for cash flow management as an endogenous variable with a t-value of 6.90. Therefore, the testing result shows a significant impact of financial literacy on cash flow management, and the first hypothesis is supported. It indicates that the behavior of MSMEs owners and managers regarding cash flow management is determined by their knowledge regarding alternative sources that can be used to obtain loans, online credit risks, and differences between legal and illegal online credits. In addition, the skills of owners or managers in managing finances, their capabilities in financial calculations such as determining the interest rate, and their familiarity with various financial products and financial issues may also affect their behavior in managing their company's cash flow. The study's results on the impact of financial literacy on financial behavior regarding cash flow management corroborate the results of previous studies (Parrotta & Johnson, 1998)(Hilgert, Hogarth, & Beverly, 2003) (Robb & Woodyard, 2011). It confirms that financial competencies and skills positively influence the behavior of MSMEs owners or managers in managing their cash flow.

The MSMEs owners' and managers' behavior in managing cash flow will determine their business performance. It is emphasized through the result of hypothesis testing regarding the determinants of cash flow management towards MSMEs performance. For MSME performance as an endogenous variable, the structural coefficient for cash flow management was positive and statistically significant, with a t-value of 4.10. Therefore, the hypothesis regarding the effect of cash flow management on MSME performance is also supported. MSMEs entrepreneurs can improve their business by consistently creating a plan regarding the company's cash flow, monitoring cash flow, and maintaining a healthy amount of contingency cash to prepare for unexpected needs. It confirms that the behavior of MSMEs owners or managers regarding cash flow management determines the MSMEs performance. Past studies showed similar results

related to the relationship between the two variables (Kakeeto, Timbirimu, Kiizah, & Osunsan, 2017) (Eton, Godfrey, Nyangoma, & Mwosi, 2019).

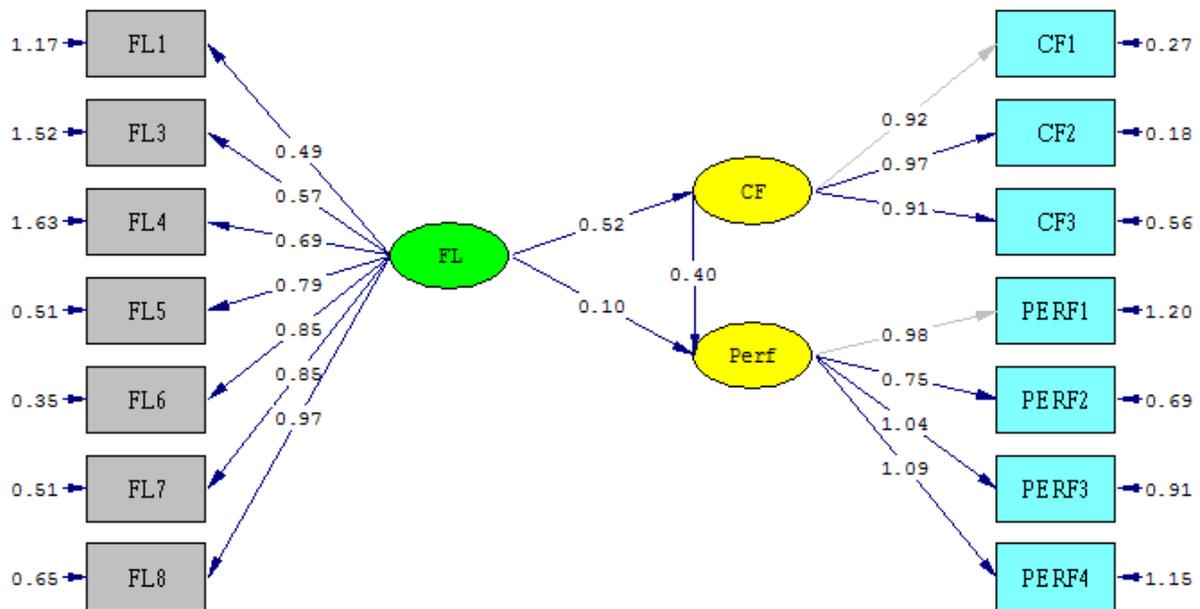


Figure 1: Structural Model Results

The results of the third hypothesis testing regarding the effect of financial literacy on the performance of MSMEs are not supported. The test result of financial literacy's impact on MSMEs performance is statistically insignificant, with a p-value of 1.10. It is not in line with previous research, which showed a direct influence of financial knowledge on the performance of MSMEs (Mazzarol, Reboud, & Clark, 2015) (Cherotich, Ayuya, & Sibiko, 2019). It indicates that competencies and skills that the owners or managers have do not correlate directly with MSMEs' performance but will affect their behavior in managing the company's cash flow, which will then determine their business' performance.

Table 2: Hypotheses Testing Results

Structural relationship	Coefficient	t-value
Financial Literacy → Cash Flow Management	0.52	6.90
Cash Flow Management → Performance	0.40	4.10
Financial Literacy → Performance	0.10	1.10

### 5. CONCLUSIONS

The study's findings contribute to the financial literacy study, especially in the context of MSMEs. The result shows a positive impact of financial literacy on cash flow management. It indicated that MSMEs owners and managers with financial knowledge

and skills would show a behavior recommended in managing cash flow, which will then determine the performance of the MSMEs.

The result also shows that financial literacy does not affect MSMEs' performance directly. It signifies the role of cash flow management as an intervening variable. MSMEs entrepreneurs need to understand the importance of understanding various matters regarding financial issues. In addition, a company needs good cash flow management to obtain profit. All operation, financing, and investment activities are connected to cash flow management.

Financial knowledge and skills are required to direct financial behavior to be better. Cash management needs to be a concern for MSMEs owners and managers, as financial management will be related to cash flow management, both cash inflows and cash outflows. MSMEs entrepreneurs aware of the importance of financial knowledge and skills can develop policies to increase the financial literacy of owners or managers. Specific programs related to cash flow management can have positive implications for their business in which they can avoid the risks of financial issues with proper cash flow management. In addition, companies can also avoid illiquidity conditions by allocating current assets, specifically in cash, to cover any current liabilities on the due date.

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