

SMEs Success: Roles of Financial Literacy, Capital Structure, and Innovation

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ABSTRACT

This study examines the roles of financial literacy and capital structure in improving SME performance, with innovation as a mediating variable. Using a quantitative causal design, data were collected from 425 SME owners and analyzed with Partial Least Squares–Structural Equation Modeling (PLS-SEM). The results show that financial literacy has a significant positive effect on innovation, but no direct effect on SME performance. In contrast, capital structure significantly affects both innovation and SME performance. Innovation also has a significant positive effect on performance and serves as a key mechanism in the model: it fully mediates the relationship between financial literacy and SME performance. It partially mediates the relationship between capital structure and SME performance. These findings contribute to the SME literature by showing that financial capability and financing decisions do not automatically improve performance unless they are translated into innovation. Practically, the study suggests that SME development programs should combine financial literacy training with innovation support. At the same time, financing policies should enable balanced capital structures that help SMEs invest in product, process, and service innovation. This study is limited by its cross-sectional design and self-reported data, which may restrict causal generalization over time.

Keywords: Financial Literacy; Capital Structure; Innovation; SME Performance.



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INTRODUCTION

Micro, small, and medium-sized enterprises (MSMEs) play a crucial role in economic development, particularly in developing countries such as Indonesia. MSMEs contribute significantly to employment generation, income distribution, and economic resilience. In Indonesia, MSMEs represent the majority of business entities and serve as an essential driver of national economic growth. Despite their strategic role, many MSMEs continue to face structural challenges that limit

their ability to achieve sustainable performance and competitiveness. One of the critical factors influencing MSME performance is financial literacy. Financial literacy refers to the ability of business owners to understand financial concepts, manage financial resources effectively, and make informed financial decisions. Adequate financial literacy enables entrepreneurs to perform proper financial planning, budgeting, record keeping, and cost calculation. These capabilities are expected to support better managerial decisions and improve firm performance. Previous studies have shown that financial literacy can positively influence financial decision-making and firm outcomes (Alafifi et al., 2019; Anshika & Singla, 2022). However, other studies suggest that financial literacy alone may not directly translate into improved business performance unless it is integrated with strategic actions such as innovation and market development. The specific mechanisms through which financial literacy influences SME performance are not fully understood. Studies suggest that financial capability, financial risk attitude, and organizational risk-taking tolerance may mediate this relationship, but more research is needed to clarify these pathways (Appiah & Venyo Agblewornu, 2024; Masdupi et al., 2024). Another important determinant of MSME performance is capital structure. Capital structure refers to the composition of internal and external funding used to finance business operations. A balanced capital structure enables firms to maintain financial stability while supporting operational activities and business expansion. For MSMEs, capital typically comes from personal savings, loans from financial institutions, cooperative financing, or government support programs. Access to adequate financing allows entrepreneurs to invest in production capacity, expand distribution networks, and improve product quality. Several studies have found that a well-managed capital structure can significantly improve the operational efficiency and financial performance of small businesses (Quintiliani et al., 2023; Dela Cruz et al., 2023).

Nevertheless, excessive reliance on debt may also create financial pressure and reduce long-term profitability (Ali et al., 2025). In addition to financial literacy and capital structure, innovation has been widely recognized as a key driver of business performance. Innovation allows firms to adapt to changing market conditions, improve product value, enhance production efficiency, and strengthen customer relationships. For MSMEs, innovation may occur in various forms, including product innovation, process innovation, and service innovation. Product innovation focuses on creating new or improved products that meet evolving customer needs. Process innovation aims to enhance operational efficiency through improved production methods or technologies. Meanwhile, service innovation improves the way businesses interact with customers, for example, through digital platforms or customized services. Prior studies highlight that innovation plays a significant role in enhancing firm competitiveness and performance (Chege et al., 2020; Tang, 2022).

Innovation in MSMEs is multifaceted, encompassing product, process, and service innovations, each contributing to different aspects of business performance and sustainability. While product innovation is often the most emphasized, process and service innovations are equally crucial for operational efficiency and customer satisfaction. Addressing barriers and adopting comprehensive innovation strategies can significantly enhance the competitiveness and sustainability of MSMEs (Casidy et al., 2020; Timotius, 2023). Despite the growing literature on MSME performance, empirical findings regarding the role of financial literacy and capital structure remain inconsistent. Some studies report a direct positive relationship between financial literacy and firm performance, while others indicate that the relationship becomes significant only when mediated by other strategic factors. Similarly, the impact of capital structure on performance may vary depending on how financial resources are utilized within the firm. However, the inconsistency of previous findings indicates a more specific research gap. First, prior studies have mostly examined the direct effect of financial literacy or capital structure on MSME performance, while limited attention has been given to the mechanism that explains how these factors are transformed into business outcomes. Second, existing studies tend to analyze financial literacy, capital structure, and innovation separately, rather than integrating them into a single empirical framework. Third, although innovation is often recognized as an important determinant of firm performance, its role as a mediating variable in linking financial capability and financing decisions to MSME performance remains underexplored, particularly in the context of MSMEs in Indonesia. Therefore, the gap in the literature lies not only

in the inconsistent results but also in the limited explanation of the process through which financial literacy and capital structure contribute to performance improvement.

Given these inconsistencies, it is important to examine the mechanism through which financial literacy and capital structure influence MSME performance. Innovation may act as a key mediating variable that transforms financial knowledge and financial resources into productive strategies that enhance business outcomes. Therefore, this study aims to investigate the influence of financial literacy and capital structure on MSME performance, with innovation as a mediating variable. By focusing on MSMEs in Indonesia, this study contributes to the literature by providing empirical evidence on how financial capabilities and financial structure can be leveraged to foster innovation and improve firm performance. The novelty of this study lies in its integrated examination of financial literacy and capital structure as antecedents of MSME performance, with innovation positioned as a mediating variable. Unlike previous studies that generally focus on partial relationships or direct effects, this study offers a more comprehensive explanation of how financial knowledge and funding decisions are converted into improved business performance through innovation. In addition, this study provides empirical evidence from the context of Indonesian MSMEs, thereby enriching the literature on MSME performance in developing economies.

Based on the research gap and novelty described above, this study addresses the following research questions:

1. Does financial literacy significantly affect innovation in MSMEs?
2. Does financial literacy significantly affect MSME performance?
3. Does capital structure significantly affect innovation in MSMEs?
4. Does capital structure significantly affect MSME performance?
5. Does innovation significantly affect MSME performance?
6. Does innovation mediate the relationship between financial literacy and MSME performance?
7. Does innovation mediate the relationship between capital structure and MSME performance?

The objective of this study is to analyze the direct effects of financial literacy and capital structure on innovation and MSME performance, and to test whether innovation mediates the relationship between financial literacy and MSME performance, as well as between capital structure and MSME performance.

Literature Review and Hypothesis Development

This study is grounded in the Resource-Based View (RBV), which argues that firm performance is influenced by the firm's ability to acquire, manage, and deploy valuable resources and capabilities effectively. RBV has significantly influenced strategic management by shifting the focus from external market conditions to internal firm-specific factors (Münter, 2026). In the context of SMEs, financial literacy can be viewed as an intangible managerial resource because it reflects the owner's ability to understand financial information, evaluate alternatives, and make sound financial decisions. The RBV provides a robust theoretical foundation for understanding how financial literacy, as an intangible resource, contributes to the performance and sustainability of SMEs. By enhancing financial decision-making capabilities, financial literacy enables SMEs to effectively acquire and manage financial resources, thereby achieving sustained competitive advantage and growth (Adomako et al., 2016). Capital structure represents a financial resource configuration that determines the firm's flexibility in funding operations and growth.

Meanwhile, innovation reflects the firm's capability to transform knowledge and financial resources into new products, improved processes, and better services. From the RBV perspective, SME performance is not determined solely by resource ownership, but by how those resources are utilized to create competitive advantage (Aveline, 2023). Therefore, innovation is positioned in this study as a strategic mechanism through which financial literacy and capital structure are converted into superior SME performance.

The Effect of Financial Literacy on Innovation

Financial literacy reflects the ability of SME owners to understand financial concepts and use that knowledge in budgeting, investment planning, financing decisions, and resource allocation. In SMEs, financial literacy is not merely an administrative skill but a managerial capability that can support business development. From the Resource-Based View (RBV), financial literacy can be treated as an intangible resource that helps owners deploy financial resources more effectively to create value through innovation. Several studies suggest that financial literacy positively supports innovation because financially literate owners are more capable of evaluating investment feasibility, managing business risk, and allocating funds to new product development or process improvement. Rosyidiana and Narsa (2024) found that financial literacy positively influences innovation in MSMEs, indicating that better financial understanding encourages firms to adopt more innovative business practices. In addition, Indrawati et al. (2025) argued that financial literacy improves access to financing, which in turn expands SMEs' ability to support innovation-related activities.

Likewise, Alafifi et al. (2019) showed that stronger financial literacy improves decision-making quality, which is essential for identifying and implementing innovative strategies. However, prior studies have often emphasized the direct role of financial literacy in improving business outcomes, while its role in stimulating innovation has received less explicit attention. This suggests that financial literacy should be understood not only as a financial management skill, but also as a capability that enables SMEs to transform financial knowledge into innovation. Therefore, financial literacy is expected to affect innovation positively.

H1: Financial literacy has a significant effect on innovation.

The Effect of Capital Structure on Innovation

Capital structure refers to the composition of equity and debt used to finance business activities. For SMEs, capital structure is highly relevant to innovation because innovation requires financial commitment, whether for technology adoption, product development, or process improvement. In the RBV perspective, capital structure represents a financial resource configuration that influences the firm's ability to build strategic capabilities such as innovation. Prior research indicates that capital structure can influence innovation through the availability and flexibility of financial resources. Quintiliani et al. (2023) found that well-managed capital structure improves firms' financial efficiency and supports value creation, including through strategic investment. Similarly, Dela Cruz et al. (2023) emphasized that access to financing plays an important role in supporting business development and adaptive capacity, which are closely linked to innovation.

However, the literature also suggests that the effect is not always linear, because excessive debt may create financial pressure and reduce the firm's willingness to take risks in innovation activities, as noted by Ali et al. (2025). This indicates that capital structure does not simply provide funds, but also shapes the firm's flexibility in pursuing innovation. SMEs with a healthier balance of equity and debt are more likely to mobilize resources toward innovation because they have greater financial room to invest in long-term development. Therefore, capital structure is expected to affect innovation positively.

H2: Capital structure has a significant effect on innovation.

The Effect of Innovation on SME Performance

Innovation refers to the firm's ability to develop new or improved products, processes, and services that create value and strengthen competitiveness. In SMEs, innovation is particularly important because these firms operate in dynamic markets and often rely on flexibility and responsiveness to survive. From the RBV perspective, innovation is a strategic capability that enables firms to transform resources into competitive advantage and performance. Several studies support the positive relationship between innovation and firm performance. Chege et al. (2020) found that innovation significantly improves firm competitiveness and performance by helping businesses adapt to market changes. Likewise, Tang (2022) showed that innovation supports business growth and strengthens firm sustainability. More specifically, Casidy et al. (2020) and Timotius (2023)

emphasized that product, process, and service innovation contribute to efficiency, customer satisfaction, and long-term competitiveness, all of which are closely associated with improved SME performance. Although the positive role of innovation is widely recognized, its effectiveness depends on whether SMEs are able to align innovation with market needs and operational capacity. Even so, the literature consistently suggests that innovation is one of the strongest drivers of SME performance. Therefore, innovation is expected to affect SME performance positively.

H3: Innovation has a significant effect on SME performance.

The Effect of Financial Literacy on SME Performance

Financial literacy is often associated with better SME performance because it improves the owner's ability to manage cash flow, plan investments, evaluate financial risks, and make more rational business decisions. In SMEs, where managerial and financial decisions are highly centralized in the owner, financial literacy becomes a critical capability for maintaining business sustainability. Previous studies generally report a positive relationship between financial literacy and SME performance. Alafifi et al. (2019) found that financial literacy improves financial decision-making, which contributes to better business outcomes. Similarly, Anshika and Singla (2022) showed that entrepreneurs with stronger financial knowledge are better able to optimize business decisions and improve operational outcomes. In addition, Quintiliani et al. (2023) argued that financial literacy plays a key role in creating value and improving the profitability of small businesses.

However, other studies indicate that financial literacy may not automatically improve performance unless it is translated into strategic actions such as innovation and market development, as suggested by Appiah and Venyo Agblewornu (2024) and Masdupi et al. (2024). These mixed findings imply that financial literacy may function both as a direct determinant of performance and as an enabling resource whose benefits depend on how the firm utilizes it. Nevertheless, from the RBV perspective, financial literacy remains a valuable managerial resource that should improve SME performance. Therefore, financial literacy is expected to affect SME performance positively.

H4: Financial literacy has a significant effect on SME performance.

The Effect of Capital Structure on SME Performance

Capital structure reflects how SMEs combine equity and debt to finance operational and strategic activities. This decision is important because it affects financial flexibility, liquidity, cost of capital, and the firm's capacity to support productive investment. In the RBV framework, capital structure is a resource arrangement that can strengthen or constrain the firm's ability to achieve superior performance. Prior studies suggest that capital structure significantly influences SME performance. Quintiliani et al. (2023) argued that an optimized capital structure can reduce financing costs and improve financial efficiency, thereby enhancing firm performance. Likewise, Dela Cruz et al. (2023) emphasized that financing availability supports business growth and operational development. However, the effect may become negative when firms rely excessively on debt, because this increases repayment burdens and financial risk, as noted by Ali et al. (2025). These findings suggest that capital structure is not merely a technical financing decision, but also a strategic factor influencing SME performance. SMEs with healthier financing structures are more likely to maintain stability, support business growth, and improve profitability. Therefore, capital structure is expected to affect SME performance positively. Based on these arguments, this study proposes the following hypothesis:

H5: Capital structure has a significant effect on SME performance.

The Effect of Financial Literacy on SME Performance through Innovation

Financial literacy may influence SME performance not only directly but also indirectly through innovation. This indirect relationship is important because financial knowledge does not always produce immediate business outcomes unless it is translated into strategic action. In the RBV perspective, financial literacy is an intangible resource, while innovation is the capability through which that resource creates value.

Empirical studies provide support for this pathway. Rosyidiana and Narsa (2024) found that financial literacy positively affects innovation, which subsequently improves MSME performance. Likewise, Anshika and Singla (2022) emphasized that financially literate entrepreneurs are better able to evaluate innovation-related risks and investment opportunities. In addition, Chege et al. (2020) and Tang (2022) showed that innovation itself has a significant role in improving firm performance. Taken together, these findings imply that financial literacy can enhance performance through its contribution to innovation. Thus, innovation can be seen as the mechanism that translates financial knowledge into concrete business improvements. SME owners with stronger financial literacy are more likely to allocate resources to innovation, and such innovation is expected to improve business performance. Therefore, innovation is expected to mediate the relationship between financial literacy and SME performance.

H6: Financial literacy has a significant effect on SME performance through innovation.

The Effect of Capital Structure on SME Performance through Innovation

Capital structure may also affect SME performance indirectly through innovation. A balanced financing structure gives SMEs the flexibility to invest in strategic activities, including product development, technology adoption, and process improvement. In RBV terms, capital structure is a financial resource arrangement, while innovation is the capability that transforms these resources into improved performance. Previous studies support this argument. Quintiliani et al. (2023) showed that an appropriate capital structure enhances firms' ability to create value, while Dela Cruz et al. (2023) highlighted the importance of financing access for supporting adaptive business development. At the same time, Chege et al. (2020) and Casidy et al. (2020) demonstrated that innovation contributes significantly to competitiveness and firm performance. These findings suggest that the value of capital structure may become stronger when financial resources are directed toward innovation activities. This means that capital structure may not influence performance only in a direct way, but also through the firm's capacity to innovate. SMEs with a well-managed financing structure are more likely to invest in innovation, and such innovation is expected to improve overall business performance. Therefore, innovation is expected to mediate the relationship between capital structure and SME performance.

H7: Capital structure has a significant effect on SME performance through innovation.

This study is designed to analyze the influence of financial literacy and capital structure on innovation and SME performance. In this context, financial literacy is positioned as a key factor that determines the ability of SME owners to manage financial resources, make investment decisions, and access appropriate financing sources. Higher levels of financial literacy enable entrepreneurs to better allocate financial resources and identify opportunities for business development. Consequently, financial literacy is expected to have a direct effect on innovation and SME performance, as well as an indirect effect through the mediating role of innovation. In addition, capital structure is considered an important variable that reflects the composition of equity and debt used to finance business activities. An optimal capital structure enables SMEs to obtain financing at a lower cost of capital, increase financial flexibility, and create opportunities to invest in innovative projects. Therefore, capital structure is expected to influence both innovation and SME performance directly. From an indirect perspective, a well-managed capital structure can encourage the development of innovation, which in turn strengthens overall business performance.

In this study, innovation is positioned as a mediating variable that bridges the relationship between financial literacy and capital structure with SME performance. Innovation is reflected in activities such as product development, improvements in business processes, and the adoption of digital technologies that enable SMEs to improve operational efficiency and expand market access. Innovation is therefore considered a key mechanism for strengthening the competitiveness of SMEs. SME performance, as the dependent variable, is measured through indicators such as revenue growth, profitability, and business sustainability. Within this research framework, SME performance is influenced directly by financial literacy and capital structure, as well as indirectly through innovation as a mediating variable. Thus, the proposed framework emphasizes that

improving financial literacy and managing capital structure effectively can stimulate innovation, which ultimately contributes to enhanced SME performance.

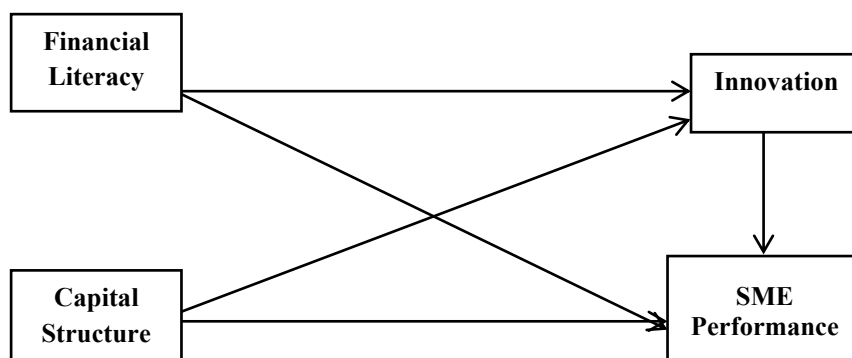


Figure. 1 Research Model

Source: Authors' own conceptual framework

METHOD

This study employs a quantitative research approach with a causal design. The purpose of this study is to examine the influence of financial literacy and capital structure on innovation and SME performance, while also analyzing the mediating role of innovation. A quantitative approach is adopted because it allows the researcher to provide empirical evidence regarding both direct and indirect relationships among the variables. The research design uses a survey method with a structured questionnaire as the main data collection instrument. The questionnaire is developed using a five-point Likert scale ranging from 1 (“Strongly Disagree”) to 5 (“Strongly Agree”). The respondents of this study are owners of Micro, Small, and Medium Enterprises (SMEs) located in East Java, Indonesia. The sampling technique applied is non-probability sampling with a minimum target of 200 respondents, which is considered sufficient for Structural Equation Modeling (Hair et al., 2019). In this study, financial literacy and capital structure are treated as exogenous variables, while innovation and SME performance are treated as endogenous variables.

A total sample of 425 valid questionnaires was collected from SME owners in East Java, Indonesia, and all were included in the final analysis. The respondents were selected based on predetermined criteria, namely being SME owners or managers who were directly involved in financial decision-making, financing activities, innovation practices, and overall business operations, and who had managed their businesses for at least one year. This sample size exceeded the minimum requirement for PLS-SEM and was therefore considered sufficient to ensure stable parameter estimation and reliable analytical results. Primary data were collected through the distribution of online questionnaires using Google Forms to SME respondents. The research instrument was developed based on measurement indicators adapted from previous studies. Financial literacy indicators were adapted from Anshika and Singla (2022) and Hj Talip and Wasiuzzaman (2024); capital structure indicators were adopted from Quintiliani, Modina, and Arnone (2023); innovation indicators were adapted from Widiyatmoko et al. (2024); and SME performance indicators were derived from Tang (2022).

Table 1. Indicator variable

Variable	Indicator	Code	Statement
Financial Literacy	Bookkeeping literacy	X11.1	I regularly record all business sales and purchase transactions in a book or application.
	Bookkeeping literacy	X11.2	I am able to prepare a simple profit and loss statement at the end of each month.

	Budgeting literacy	X12.1	I prepare a monthly budget for business expenses.
	Budgeting literacy	X12.2	I compare actual expenditures with the established budget.
	Debt literacy	X13.1	I only use business loans when they are truly necessary.
	Debt literacy	X13.2	I consider my repayment ability before taking a loan from a bank or cooperative.
	Cost of goods manufactured literacy	X14.1	I calculate the cost of goods manufactured based on raw material, labor, and overhead costs.
	Cost of goods manufactured literacy	X14.2	I determine the selling price of my products based on the cost of goods manufactured plus a profit margin.
Capital Structure	Debt-to-equity proportion	X21.1	Most of my business capital comes from loans rather than personal capital.
	Debt-to-equity proportion	X21.2	I rely more on personal capital than on loans to run my business.
	Dependence on debt	X22.1	I often increase my business capital by borrowing money, for example from banks or cooperatives.
	Dependence on debt	X22.2	The growth of my business depends heavily on additional capital obtained through loans.
	Awareness of debt-to-equity ratio	X23.1	I know the proportion between borrowed capital and personal capital in my business.
	Awareness of debt-to-equity ratio	X23.2	I try to ensure that the amount of debt does not exceed the personal capital I have invested in my business.
	Debt burden management	X24.1	I consider the ratio between debt and personal capital before taking a new loan.
	Debt burden management	X24.2	I believe that the amount of debt I currently have is still balanced with my personal capital.
Innovation	Product innovation	Y11.1	I make changes to product taste or packaging to attract more customers.
	Product innovation	Y11.2	I create new products every year to keep up with market trends.
	Process innovation	Y12.1	I continuously upgrade equipment or machinery to save time and reduce costs.
	Process innovation	Y12.2	I use alternative raw materials to improve production efficiency.
	Service innovation	Y13.1	I serve customer orders through online applications such as WhatsApp, Shopee, or Tokopedia.
	Service innovation	Y13.2	I provide delivery services to improve customer satisfaction.
SME Performance	Financial performance	Y21.1	My business revenue has increased by at least 10% over the past year.

Financial performance	Y21.2	My business profit is stable or increases every month.
Operational performance	Y22.1	I am able to fulfill 95% of customer orders on time as promised.
Operational performance	Y22.2	The level of customer complaints about my products or services has decreased over the past year.

Source: Author 2025

The collected data were analyzed using Structural Equation Modeling (SEM) based on Partial Least Squares (PLS) with the assistance of SmartPLS 3.0 software. The analysis was conducted through several stages:

1. Validity and reliability testing to ensure the accuracy and consistency of the measurement instruments.
2. Measurement model evaluation (outer model) to assess the validity and reliability of the construct indicators.
3. Structural model evaluation (inner model) to examine the relationships among the variables.
4. Path significance testing to determine the direct and indirect effects between variables, including the mediating role of innovation.

RESULTS AND DISCUSSION

Measurement Model Evaluation (Outer Model)

The measurement model analysis was conducted to assess the validity and reliability of the research instruments. Convergent validity was evaluated using the loading factor and Average Variance Extracted (AVE), while reliability was assessed using Cronbach's Alpha (CA) and Composite Reliability (CR). Based on the results of the PLS Algorithm analysis, all indicators showed loading factor values above 0.70, indicating that each indicator adequately represents its respective construct. Furthermore, the AVE values for all constructs exceeded the recommended threshold of 0.50, confirming that convergent validity was achieved. In terms of reliability, the Cronbach's Alpha values for all constructs were above 0.70, while Composite Reliability values exceeded 0.80.

These results indicate that the measurement instruments demonstrate good internal consistency and reliability. Therefore, the constructs used in this study are considered reliable and suitable for further structural model testing. In addition, discriminant validity was examined using cross-loading analysis and the Fornell-Larcker criterion. The results indicate that each construct loads more strongly on its own indicators than on indicators of other constructs, satisfying the discriminant validity requirement. This finding confirms that the constructs examined in this study, financial literacy, capital structure, innovation, and SME performance, are conceptually distinct and measure different aspects of the research model.

Structural Model Evaluation (Inner Model)

After confirming that the measurement model met the required validity and reliability criteria, the next step involved evaluating the structural model (inner model). The structural model assessment was conducted by examining the coefficient of determination (R^2), effect size (f^2), and predictive relevance (Q^2).

1. Coefficient of Determination (R^2)

The innovation variable obtained an R^2 value of 0.659, indicating that financial literacy and capital structure jointly explain 65.9% of the variance in innovation, while the remaining 34.1% is influenced by other factors outside the research model. Meanwhile, SME performance achieved an R^2 value of 0.697, suggesting that financial literacy, capital structure, and innovation together explain 69.7% of the variance in SME performance. According to Chin (1998), this value can be categorized as substantial, indicating that the model has strong explanatory power.

2. Effect Size (f^2)

The effect size (f^2) was used to assess the relative predictive impact of each exogenous variable on the endogenous variables. The results indicate that financial literacy has a substantial effect on innovation ($f^2 > 0.35$), while capital structure shows a moderate effect on innovation ($f^2 > 0.15$). Furthermore, innovation demonstrates a strong effect on SME performance, highlighting its important role as a mediating variable within the research model.

3. Predictive Relevance (Q^2)

Predictive relevance was evaluated using the Stone–Geisser Q^2 test. The obtained Q^2 values were positive, indicating that the model has satisfactory predictive relevance. This result confirms that the structural model possesses adequate capability to explain and predict the relationships among the variables examined in this study.

4. Visualization of the Research Model

The results of the PLS Algorithm analysis are visualized in the path diagram presented in Figure 1, while the bootstrapping results are illustrated in Figure 2. These figures demonstrate the strength of the relationships among the variables. The results indicate that financial literacy has the strongest influence on innovation, while innovation plays a significant role in improving SME performance.

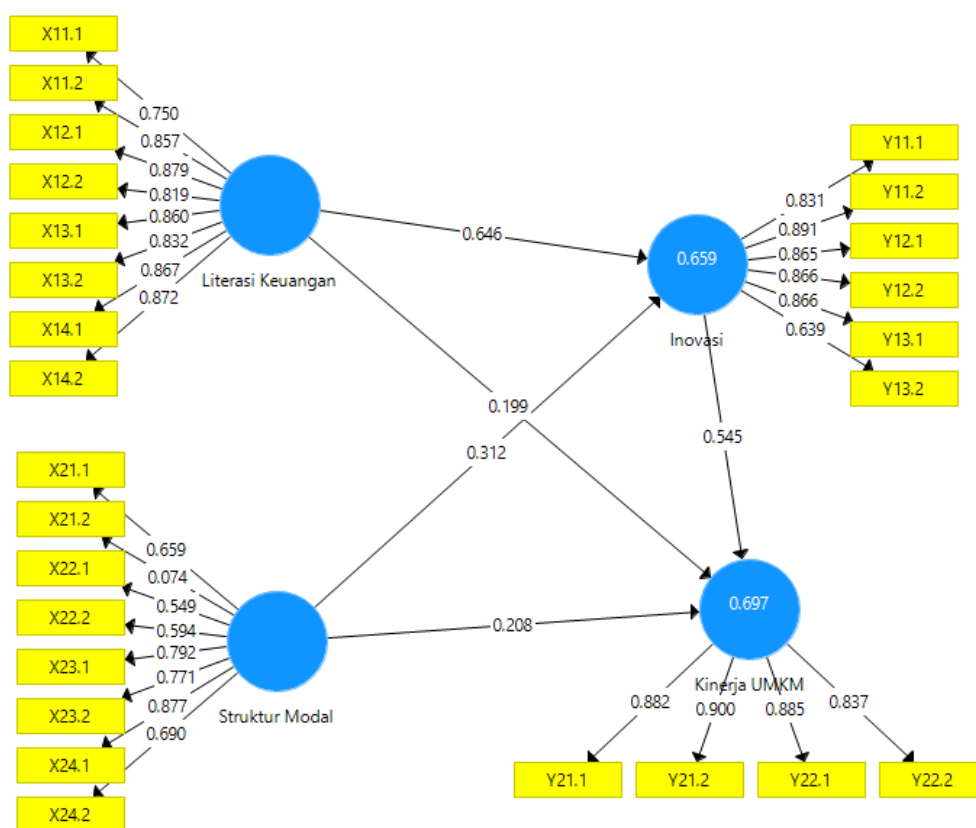


Figure 2. Structural Model Results (PLS Algorithm)

Source: Data Processing by the Author

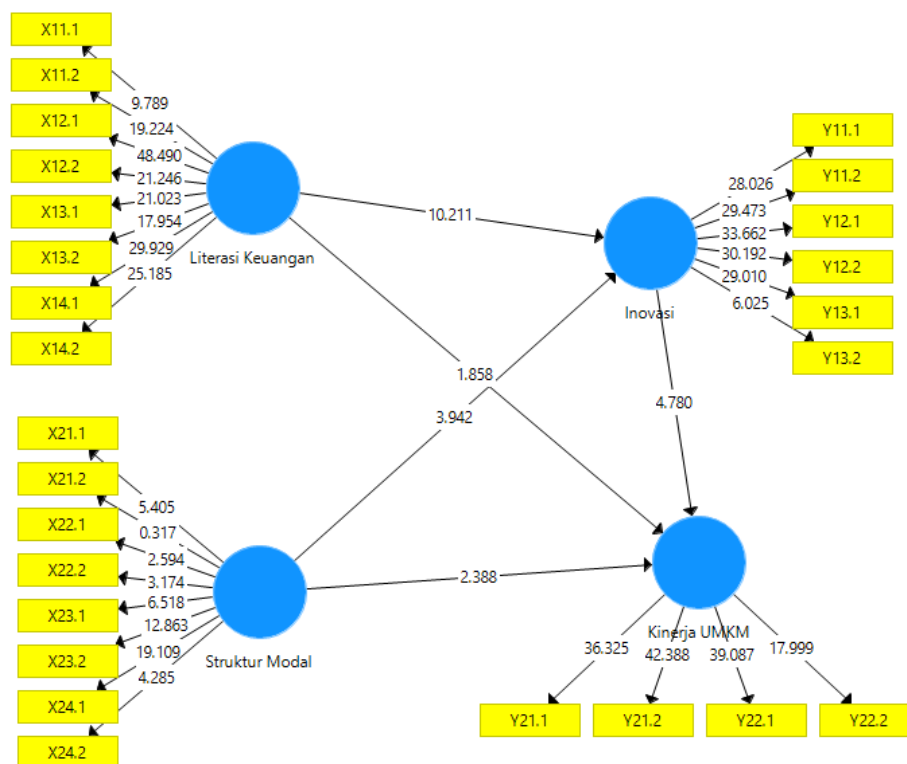


Figure 3. Bootstrapping

Source: Data Processing by the Author

Hypothesis Testing

Direct Effect Analysis

Hypothesis testing was conducted using the bootstrapping procedure with 425 samples. The results of the hypothesis testing are presented in Table 2.

Table 2. Results of Hypothesis Testing (PLS-SEM)

Hypothesis	Path Coefficient (β)	t-Statistic	p-Value	Result
H1: Financial Literacy → Innovation	0.646	10.211	0.000	Significant
H2: Capital Structure → Innovation	0.312	3.942	0.000	Significant
H3: Innovation → SME Performance	0.545	4.780	0.000	Significant
H4: Financial Literacy → SME Performance	0.199	1.858	0.063	Not significant
H5: Capital Structure → SME Performance	0.208	2.388	0.017	Significant

Source: Author 2025

Based on the results presented in Table 2 and the structural model diagram, several conclusions can be drawn:

1. Financial Literacy → Innovation

The relationship between financial literacy and innovation is positive and statistically significant, with a path coefficient of 0.646. This result indicates that higher levels of financial literacy among SME owners enhance their ability to generate and implement innovative ideas within their businesses.

2. Capital Structure → Innovation

Capital structure also has a significant positive effect on innovation, with a coefficient of 0.312. This finding suggests that a balanced capital structure can facilitate innovative activities within SMEs, although its contribution is smaller compared to financial literacy.

3. Innovation → SME Performance

Innovation has a significant positive effect on SME performance with a coefficient of 0.545. This result confirms that innovation plays a crucial role in improving business outcomes. It also indicates that innovation serves as a key mechanism through which financial and managerial capabilities can translate into improved performance.

4. Financial Literacy → SME Performance

Although the path coefficient is positive (0.199), the relationship between financial literacy and SME performance is not statistically significant. This finding implies that financial literacy alone may not be sufficient to directly improve SME performance unless it is translated into innovative activities.

5. Capital Structure → SME Performance

The relationship between capital structure and SME performance is positive and statistically significant, with a coefficient of 0.208. This result indicates that effective capital structure management contributes directly to improving SME performance.

Indirect Effect Analysis (Mediation Test)

In addition to direct effects, this study also examines indirect effects to evaluate the mediating role of innovation. The results of the mediation analysis using the bootstrapping method are presented in Table 3.

Table 3. Indirect Effect Results (Mediation Analysis)

Mediation Path			Path Coefficient (β)	t-Statistic	p-Value	Result
Financial Literacy	→	Innovation	0.352	4.917	0.000	Significant (Full mediation)
Innovation	→	SME Performance				
Capital Structure	→	Innovation	0.170	3.128	0.002	Significant (Partial mediation)
Innovation	→	SME Performance				

Source: Author 2025

1. Financial Literacy → Innovation → SME Performance

This mediation path shows a strong and significant indirect effect ($\beta = 0.352$; $p < 0.001$). Since the direct effect of financial literacy on SME performance is not significant, innovation fully mediates the relationship between financial literacy and SME performance. This finding suggests that financial literacy can improve SME performance only when it is translated into innovative actions such as product development, process improvements, or service innovation.

2. Capital Structure → Innovation → SME Performance

This mediation path is also statistically significant ($\beta = 0.170$; $p < 0.01$). However, because the direct effect of capital structure on SME performance remains significant, the mediation effect is categorized as partial mediation. This means that capital structure influences SME performance both directly and indirectly through innovation. SMEs with a balanced capital structure can utilize financial resources not only to strengthen operational activities but also to finance innovation initiatives that enhance competitiveness.

The Effect of Financial Literacy on Innovation

The finding that financial literacy has a positive and significant effect on innovation suggests that financial literacy should be understood not merely as a technical or administrative competence, but as a strategic managerial capability that enables SME owners to transform financial knowledge into business development actions. In the context of this study, SME owners who are able to record transactions, prepare simple financial statements, manage budgets, and calculate production costs are better positioned to identify opportunities, evaluate risks, and allocate resources toward innovation-oriented activities. This indicates that financial literacy strengthens the entrepreneur's capacity to make informed decisions regarding product improvement, process efficiency, and service enhancement. From the perspective of the Resource-Based View (RBV), this result confirms that financial literacy can be treated as an intangible resource that contributes to the development of firm capability, particularly innovation. RBV argues that firms achieve superior performance not merely because they possess resources, but because they are able to deploy those resources effectively to create value and competitive advantage. In this study, financial literacy appears to function as an enabling resource that supports the firm's innovative capability. In other words, financial knowledge becomes strategically meaningful when it is translated into concrete innovation activities, such as redesigning products, improving packaging, adopting digital platforms, or enhancing service delivery. This interpretation provides a deeper explanation of why financially literate SME owners tend to be more innovative: they are better able to connect financial understanding with strategic business adaptation. This finding is consistent with Rosyidiana and Narsa (2024), who found that financial literacy encourages innovation in SMEs, especially through business digitalization. It is also in line with Widiyatmoko et al. (2024), who reported that financial literacy is closely associated with the adoption of financial technology, which in turn facilitates service innovation and improves operational efficiency. The present study extends these earlier findings by showing that the role of financial literacy in innovation is not limited to digital finance adoption, but also includes broader innovation activities related to products, processes, and services. Thus, this study strengthens the argument that financial literacy is not only relevant for financial management outcomes but also for the development of strategic capabilities in SMEs.

At the same time, this result differs from Dwiputri et al. (2023), who suggested that financial literacy does not necessarily lead directly to stronger business outcomes, but is more closely associated with encouraging innovative behavior. Rather than weakening the present finding, this difference actually provides an important insight. It indicates that the value of financial literacy may be highly context-dependent, particularly in SME settings where owners face constraints in capital, technology, and market access. In the Indonesian SME context, financial literacy may be especially important because owners are often required to make independent financial and strategic decisions under conditions of uncertainty. As a result, financial literacy may first manifest in the form of innovation capability before being reflected in broader performance outcomes. This interpretation helps explain why financial literacy may have a strong effect on innovation, even when its direct effect on performance is not always consistent across studies. Theoretically, this finding contributes to the SME literature by clarifying the mechanism through which financial literacy creates value. Much of the previous literature has focused on the direct relationship between financial literacy and firm performance. However, the present study shows that such a direct relationship may overlook an important intermediate process, namely the development of innovation. Therefore, this study supports the view that intangible managerial resources do not automatically generate business outcomes unless they are mobilized through strategic capability.

In this respect, innovation acts as the channel through which financial literacy is converted into business relevance and competitive responsiveness. This provides a stronger theoretical justification for positioning innovation not merely as an additional variable, but as a key explanatory mechanism in the relationship between financial literacy and SME outcomes. Practically, the finding implies that programs aimed at strengthening SME competitiveness should not treat financial literacy as a stand-alone training agenda. Financial literacy development will be more effective when combined with innovation support, such as product development assistance, digital marketing adoption,

production improvement, and service redesign. For policymakers and SME support institutions, this means that improving bookkeeping, budgeting, and cost calculation skills should be linked directly to innovation-oriented mentoring so that financial knowledge can be translated into measurable business improvements.

The Effect of Capital Structure on Innovation

The finding that capital structure has a positive and significant effect on SME innovation indicates that financing decisions are not merely operational concerns, but also strategic determinants of a firm's innovative capacity. In the context of SMEs, a balanced combination of internal financing and external funding provides the financial flexibility needed to pursue innovation-oriented activities. This includes investing in new equipment, improving production processes, developing new products, and adopting digital technologies to respond to changing market demands. Thus, capital structure should be understood not only as a financial arrangement, but as a resource configuration that shapes the firm's ability to generate innovation. From the perspective of the Resource-Based View (RBV), capital structure represents a form of financial resource configuration that can either enable or constrain the development of strategic capabilities.

SMEs do not innovate simply because they possess financial resources, but because they are able to allocate and deploy those resources effectively in support of value-creating activities. In this study, a healthier capital structure appears to strengthen SMEs' capacity to absorb risk, support long-term investment, and maintain the flexibility required for innovation. This suggests that financing structure influences innovation not only through resource availability but also through the firm's confidence and ability to undertake strategic change. This finding is consistent with Quintiliani, Modina, and Arnone (2023), who showed that an optimal capital structure can reduce the cost of capital and encourage firms to invest in innovation-related activities. It is also in line with Wang et al. (2025), who found that financial flexibility significantly enhances green innovation outcomes, particularly in firms with strong adaptive capabilities and supportive institutional structures. The present study extends these findings by showing that, in the SME context, the role of capital structure is not limited to improving financial efficiency, but also includes strengthening the firm's capability to convert financing into sustainable innovation. In other words, capital structure matters not only because it provides funds, but because it enables firms to mobilize those funds for strategic business adaptation. At the same time, this result differs from Ali et al. (2025), who argued that excessive reliance on debt may weaken the role of capital structure in supporting innovation, especially in low-technology sectors. This difference is theoretically meaningful because it suggests that the effect of capital structure on innovation is conditional rather than uniform. In the context of Indonesian SMEs, a positive capital structure does not necessarily imply a high proportion of debt, but rather a financing composition that remains manageable and supportive of business development. Many SMEs may combine personal capital with limited external financing in a way that preserves control while still expanding investment capacity. As a result, the positive effect observed in this study may reflect the importance of financing balance, rather than debt intensity alone.

Theoretically, this finding contributes to the SME and innovation literature by reinforcing the idea that financial resources do not automatically produce innovation unless they are configured in ways that support capability development. Much of the previous literature has focused on whether capital structure improves performance or firm value. Still, less attention has been given to its role in shaping innovation capability in SMEs. The present study addresses this gap by showing that capital structure can be interpreted as an enabling condition for innovation, particularly when financing decisions provide sufficient flexibility for firms to respond to market opportunities and environmental change. This strengthens the RBV argument that competitive outcomes depend not only on the possession of resources, but also on how those resources are structured and deployed. Practically, the finding implies that SME development policies should not focus only on expanding access to credit, but also on helping SMEs manage their financing structure more effectively. Business support programs should encourage SME owners to balance internal and external funding in a way that supports innovation without creating excessive financial pressure. For financial

institutions and policymakers, this means that financing schemes for SMEs should be designed not only to increase capital access but also to facilitate productive investment in technology, product development, and service improvement.

The Effect of Capital Structure on Innovation

The positive and significant effect of capital structure on SME innovation indicates that financing decisions should be understood not merely as technical financial arrangements, but as strategic conditions that shape a firm's capacity to innovate. For SMEs, innovation often requires financial flexibility to invest in new equipment, improve production methods, develop new products, and adopt digital technologies. Therefore, a balanced capital structure not only provides access to funds but also creates the financial room needed for firms to undertake innovation-oriented activities more sustainably. From the perspective of the Resource-Based View (RBV), capital structure may be interpreted as a financial resource configuration that influences the firm's ability to build strategic capabilities. In this study, SMEs with healthier financing arrangements appear to be better able to deploy financial resources toward value-creating activities, particularly innovation. This finding suggests that the role of capital structure is not limited to funding availability alone; rather, it also affects the firm's willingness and ability to absorb risk, support long-term investment, and adapt to market change. In other words, financial resources become strategically meaningful when they are organized in a way that enables innovation. This finding is consistent with Quintiliani, Modina, and Arnone (2023), who showed that an optimal capital structure can reduce the cost of capital and encourage firms to invest in innovation-related activities. It is also in line with Wang et al. (2025), who found that balanced financing management provides financial flexibility that supports experimentation in both product and process innovation. However, the present study extends these earlier findings by showing that, in the SME context, capital structure contributes to innovation not only by improving financial efficiency, but also by strengthening the firm's capability to convert financing into strategic business adaptation.

At the same time, this result differs from Ali et al. (2025), who argued that excessive reliance on debt may weaken the effectiveness of capital structure in supporting innovation, especially in low-technology sectors. This difference is important because it suggests that the relationship between capital structure and innovation is not uniform across contexts. In Indonesian SMEs, a positive capital structure does not necessarily imply heavy dependence on debt, but rather a financing composition that remains manageable and supportive of business development. Many SMEs may combine personal capital with limited external funding in a way that preserves financial control while still enabling investment in innovation. Thus, the positive effect identified in this study may reflect the importance of financing balance, rather than debt intensity alone. Theoretically, this finding contributes to the SME and innovation literature by reinforcing the argument that financial resources do not automatically generate innovation unless they are structured in ways that support capability development. Much of the prior literature has emphasized the relationship between capital structure and firm performance, but has paid less attention to how financing structure shapes innovation capability in SMEs. This study addresses that gap by showing that capital structure can function as an enabling condition for innovation, particularly when financial decisions provide sufficient flexibility for firms to respond to market opportunities and environmental change. This interpretation strengthens the RBV perspective that competitive advantage depends not only on the possession of resources, but also on how those resources are configured and deployed.

Practically, the finding implies that SME development initiatives should not focus solely on increasing access to credit, but also on improving SMEs' ability to manage financing structures in a balanced and sustainable way. For policymakers and financial institutions, this means that financing programs should be designed not only to expand capital access but also to support productive investment in technology adoption, product development, and process improvement. For SME owners, the result highlights the importance of maintaining an appropriate balance between internal and external financing so that innovation can be pursued without creating excessive financial pressure.

The Effect of Financial Literacy on SME Performance

The finding that financial literacy does not have a significant direct effect on SME performance suggests that financial knowledge alone is not sufficient to produce immediate business outcomes. Although SME owners may understand bookkeeping, budgeting, financial reporting, and cost calculation, such knowledge does not automatically lead to higher revenue, profitability, or business growth unless it is translated into strategic action. This result indicates that financial literacy should not be viewed as a direct performance driver in all contexts, but rather as an enabling capability whose value depends on how it is utilized within the business. From the perspective of the Resource-Based View (RBV), financial literacy can be understood as an intangible managerial resource. However, RBV also emphasizes that resources do not create competitive advantage merely by being possessed; they must be effectively deployed through organizational capabilities. In this study, the absence of a direct effect suggests that financial literacy, by itself, may be more closely associated with improving internal financial control than with generating immediate market or financial outcomes. In other words, financial literacy helps SME owners reduce errors, manage cash flow more carefully, and avoid financial mismanagement. Still, it does not necessarily improve performance unless it is combined with other strategic capabilities such as innovation, market expansion, or stronger financing capacity.

This interpretation is highly relevant in the context of Indonesian SMEs, where many business owners have begun applying basic financial management practices but often use them primarily for administrative purposes rather than for strategic business transformation. For example, entrepreneurs may be capable of recording transactions and calculating production costs accurately, yet without using that information to redesign products, adjust pricing strategies, improve marketing, or enter new markets, the impact on performance may remain limited. This indicates that the problem is not the absence of financial knowledge, but the limited ability to convert that knowledge into competitive business action. The present finding differs from Anshika and Singla (2022), who reported that financial literacy has a direct positive effect on SME performance. One possible explanation is that the effectiveness of financial literacy may vary across business environments. In contexts where SMEs have better market access, stronger institutional support, or fewer financial constraints, financial literacy may translate more directly into performance improvement. By contrast, the current finding is consistent with Mongan et al. (2025), who argued that financial literacy does not significantly influence financial performance when complementary business strategies do not support it. It also aligns with Parmitasari et al. (2023), who suggested that the positive contribution of financial literacy to performance often depends on mediating or supporting factors, such as institutional programs, external support, or strategic capabilities.

Theoretically, this finding contributes to the SME literature by clarifying that the relationship between financial literacy and performance is not always linear or direct. Much of the previous literature has treated financial literacy as a predictor of better business outcomes, yet the present study shows that this assumption may oversimplify the actual mechanism. The result supports the argument that managerial knowledge becomes economically meaningful only when it is transformed into value-creating activities. Therefore, this study strengthens the position that financial literacy should be understood as a foundational resource that requires complementary capabilities, particularly innovation, in order to influence SME performance more substantially. Practically, the finding implies that programs aimed at improving SME performance should not stop at financial literacy training alone. Teaching SME owners how to record transactions, prepare budgets, and calculate costs is important. Still, such training will have a limited impact if it is not linked to innovation development, market strategy, and business expansion support. For policymakers, business development agencies, and SME support institutions, this means that financial literacy programs should be integrated with practical mentoring on product development, digital marketing, pricing strategy, and technology adoption so that financial knowledge can be converted into measurable business outcomes.

The Effect of Capital Structure on SME Performance

The finding that capital structure has a positive and significant effect on SME performance indicates that financing decisions are not merely technical financial matters, but strategic determinants of business sustainability and growth. A balanced combination of internal capital and external financing allows SMEs to maintain operational continuity, expand production capacity, and respond more effectively to market opportunities. This suggests that capital structure contributes to performance not only by increasing the availability of funds but also by improving the firm's flexibility in allocating resources to productive activities. From the perspective of the Resource-Based View (RBV), capital structure can be understood as a financial resource configuration that influences the firm's ability to create value and sustain competitiveness. RBV emphasizes that firm performance depends not only on the possession of resources, but also on how those resources are structured and deployed. In this study, a healthier capital structure appears to strengthen SMEs' capacity to support operational activities, absorb financial pressure, and invest in growth-oriented strategies. Therefore, the positive relationship identified in this study suggests that financing balance is an important condition for transforming financial resources into superior business performance.

This finding is especially relevant in the context of Indonesian SMEs, where many firms still rely heavily on personal capital but increasingly complement it with external financing from cooperatives, rural banks, or government support programs. In such a setting, external financing may not be used as a substitute for internal capital, but rather as a complementary resource to strengthen business operations and support expansion. For example, additional funding may enable SMEs to purchase production equipment, improve product quality, increase production volume, or expand distribution channels through both conventional and digital platforms. This indicates that the contribution of capital structure to performance depends not only on the amount of financing available, but also on whether financing is directed toward productive and value-generating uses. The present finding is consistent with Dela Cruz et al. (2023), who emphasized that a well-managed capital structure significantly contributes to SME financial performance, particularly when entrepreneurs are able to maintain an appropriate balance between equity and debt. It is also in line with Quintiliani, Modina, and Arnone (2023), who found that capital structure plays an important role in improving operational efficiency and supporting effective investment decisions in small businesses. The current study extends these findings by showing that, in the SME context, capital structure improves performance not only through financial efficiency, but also through its role in supporting operational resilience and market expansion.

At the same time, this result differs from Ali et al. (2025), who argued that excessive dependence on debt may reduce business performance because rising financing costs and interest burdens weaken long-term profitability. This difference is theoretically important because it suggests that the effect of capital structure on performance is not unconditional. In the Indonesian SME context, positive performance effects may emerge because external financing tends to be used selectively and cautiously, particularly for productive purposes rather than consumptive needs. This means that the positive role of capital structure observed in this study may reflect the importance of managed and disciplined financing decisions, rather than debt expansion itself. Theoretically, this finding contributes to the SME literature by clarifying that capital structure should not be viewed solely as a financial ratio or a technical funding decision. Instead, it should be interpreted as a strategic mechanism through which SMEs gain the financial flexibility needed to sustain operations, invest in development, and improve competitiveness. Much of the prior literature has focused on the relationship between capital structure and firm profitability. Still, the present study adds to the discussion by showing how balanced financing can support broader dimensions of SME performance in a developing economy context. This reinforces the RBV argument that resources contribute to performance when they are configured in ways that support strategic action.

Practically, the finding implies that SME development efforts should focus not only on improving access to external financing but also on strengthening SMEs' ability to manage financing composition effectively. For policymakers and financial institutions, this means that financing

schemes should be designed to encourage productive use of capital, support business expansion, and avoid excessive debt dependence. For SME owners, the result highlights the importance of balancing internal and external financing so that capital can be used to improve operational efficiency, expand market reach, and strengthen long-term business performance.

The Mediating Role of Innovation in the Relationship between Financial Literacy and SME Performance

The finding that innovation fully mediates the relationship between financial literacy and SME performance provides an important insight into how financial knowledge creates business value. The non-significant direct effect of financial literacy on SME performance indicates that financial literacy alone is not sufficient to generate immediate improvements in revenue, profitability, or business growth. Instead, financial literacy becomes economically meaningful when it is translated into innovation-related actions. This means that the contribution of financial literacy to performance is indirect and operates through the firm's ability to transform financial understanding into product, process, or service improvements. From the perspective of the Resource-Based View (RBV), financial literacy can be interpreted as an intangible managerial resource. At the same time, innovation represents the strategic capability through which that resource is converted into a competitive advantage. RBV argues that resources do not automatically improve firm outcomes unless they are effectively deployed in value-creating activities. In the present study, financial literacy appears to strengthen SME performance only when it supports innovation, suggesting that financial knowledge is not a stand-alone determinant of performance but rather a foundational capability that requires strategic application.

This interpretation explains why the direct path from financial literacy to performance is not significant, while the indirect path through innovation is significant. This result is particularly relevant in the context of Indonesian SMEs, where many entrepreneurs have started to apply basic financial practices such as bookkeeping, budgeting, and simple financial reporting, but often use these practices mainly for administrative control rather than for strategic business development. Financial information begins to generate tangible performance benefits only when it is used to identify opportunities for improvement, reduce inefficiencies, adjust pricing, support product diversification, or guide service enhancement. In other words, what matters is not only whether SME owners possess financial knowledge, but whether they are able to mobilize that knowledge into innovative business action. The present finding is consistent with Tang (2022), who emphasized that innovation functions as an important pathway through which managerial capabilities influence business performance. It also supports the broader argument that innovation is a critical mechanism linking internal firm resources to competitive outcomes. However, this result differs from Anshika and Singla (2022), who found that financial literacy can directly influence SME performance without the need for a mediating mechanism. This difference is theoretically meaningful because it suggests that the role of financial literacy may vary across contexts. In business environments with stronger market access, better institutional support, or lower structural constraints, financial literacy may be translated more directly into performance improvement.

By contrast, in the Indonesian SME context, where firms often face limitations in technology, market reach, and business scale, innovation appears to be the necessary channel through which financial literacy becomes performance-relevant. Theoretically, this finding contributes to the SME literature by clarifying that the relationship between financial literacy and performance is better understood as a capability-building process rather than a simple direct effect. Much of the prior literature has assumed that higher financial literacy automatically leads to better business outcomes. The present study challenges that assumption by showing that financial literacy may first need to stimulate innovation before it can improve performance. This strengthens the RBV perspective by demonstrating that intangible managerial resources create value only when they are transformed through strategic capability. Thus, innovation should not be viewed merely as an additional explanatory variable, but as a central mechanism that explains how financial literacy affects SME performance. Practically, the finding implies that SME development programs should move beyond

stand-alone financial literacy training. Teaching entrepreneurs how to prepare budgets, calculate costs, and record transactions is important. Still, these skills will have a limited impact on performance unless they are linked to innovation-oriented business support. For policymakers, training institutions, and SME development agencies, this means that financial literacy programs should be integrated with practical mentoring in product development, process improvement, digital adoption, pricing strategy, and service innovation. Such integration would help SMEs convert financial knowledge into measurable improvements in competitiveness, efficiency, and long-term business sustainability.

The Mediating Role of Innovation in the Relationship between Capital Structure and SME Performance

The finding that innovation partially mediates the relationship between capital structure and SME performance indicates that capital structure contributes to performance through two complementary pathways. On the one hand, a well-managed capital structure has a direct effect on SME performance because it strengthens liquidity, supports operational continuity, and increases the firm's ability to finance productive activities. On the other hand, capital structure also affects performance indirectly by providing the financial flexibility needed to undertake innovation in products, processes, and services. This means that capital structure not only improves performance as a financial arrangement but also as an enabling condition that supports the development of innovation capability. From the perspective of the Resource-Based View (RBV), capital structure can be interpreted as a financial resource configuration. At the same time, innovation represents the strategic capability through which those resources are transformed into superior business outcomes. RBV emphasizes that resources create value not simply because they are available, but because they are organized and deployed in ways that support competitive advantage. In this study, the direct effect of capital structure on performance suggests that financing balance itself already contributes to business stability and operational growth. At the same time, the significant indirect effect through innovation shows that part of the value of capital structure is realized when financial resources are directed toward innovation-related investments. This is why the mediation is partial rather than full: capital structure influences performance both independently and through innovation.

This finding is particularly relevant in the context of Indonesian SMEs, where additional financing from loans, cooperatives, or government assistance is often used not only to maintain operations but also to strengthen business development. For example, external financing may be used to purchase packaging equipment, improve product appearance, adopt digital sales channels, or increase production efficiency, all of which can enhance competitiveness and customer value. At the same time, internal capital is often used to support routine operational needs and maintain business continuity. This financing pattern illustrates that capital structure plays a dual role: it directly sustains performance through operational support and indirectly improves performance through innovation funding. The present finding is consistent with Quintiliani et al. (2023), who emphasized that an optimal capital structure can expand firms' innovation capacity and ultimately improve business performance. The current study extends these findings by showing more explicitly that, in SMEs, the contribution of capital structure to performance is not solely financial in nature, but also strategic because it facilitates innovation. However, this result differs from Ali et al. (2025), who argued that excessive reliance on debt may weaken the positive effect of capital structure on innovation, particularly in low-technology sectors. This difference is theoretically meaningful because it suggests that the impact of capital structure depends not merely on the presence of external financing, but on how that financing is managed. In the Indonesian SME context, debt may support rather than hinder innovation when it is used selectively, remains manageable, and is allocated to productive business purposes.

Theoretically, this finding contributes to the SME literature by clarifying that the relationship between capital structure and performance should not be understood only as a direct financial effect. Instead, the present study shows that innovation serves as an important intermediate mechanism through which financing decisions generate broader business value. This strengthens the RBV

perspective by demonstrating that financial resources contribute to performance not only through immediate operational benefits but also through their role in supporting capability development. The finding of partial mediation is especially important because it shows that capital structure has both an immediate economic function and a longer-term strategic function through innovation. Practically, the finding implies that SME development policies should focus not only on improving access to finance, but also on ensuring that financing is linked to productive and innovation-oriented use. For policymakers and financial institutions, this means that loan schemes and support programs should be designed to encourage investment in technology adoption, product improvement, packaging development, and process efficiency. For SME owners, the result highlights the importance of managing internal and external financing in a balanced way so that capital can simultaneously support day-to-day operations and longer-term innovation. Such a strategy will strengthen competitiveness, improve performance, and enhance business sustainability over time.

CONCLUSION

This study concludes that financial literacy, capital structure, and innovation are important and interconnected determinants of SME performance. The findings show that financial literacy has a positive effect on innovation, but no direct significant effect on SME performance. In contrast, capital structure has a positive and significant effect on both innovation and SME performance, while innovation itself significantly improves SME performance. The mediation analysis further reveals that innovation fully mediates the relationship between financial literacy and SME performance, and partially mediates the relationship between capital structure and SME performance. These results indicate that financial knowledge and financial resources generate stronger business outcomes when they are translated into innovation. From a theoretical perspective, this study contributes to the SME literature by showing that financial literacy and capital structure should not be understood only as direct predictors of performance, but also as strategic resources whose value depends on the firm's ability to develop innovation. This finding strengthens the Resource-Based View (RBV) by confirming that resources create competitive advantage only when they are effectively transformed into capabilities, particularly innovation. From a practical perspective, the findings imply that SME owners should use financial knowledge not only for bookkeeping and budgeting, but also for making strategic decisions related to product development, process improvement, and service innovation. At the same time, maintaining a balanced capital structure is essential to support operational stability, innovation, investment, and business expansion. For policymakers and SME support institutions, this study suggests the need to integrate financial literacy programs, innovation support, and accessible financing schemes in order to improve SME competitiveness and long-term sustainability. For future research, it is recommended that additional variables such as digital marketing capability, institutional support, entrepreneurial orientation, or business networks be included to provide a broader explanation of SME performance. Future studies may also use a wider geographic scope or a longitudinal design to capture changes in SME performance over time better.

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