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Impact of Financial Literacy on the Sustainability of Small and Medium Enterprises, Mediating Effect of Financial Management Practices

Abstract

Small and medium enterprises' viability and sustainability are measured through financial literacy, with an emphasis on the mediating effect of methods of managing finances. Mostly SMEs across the sector struggle with sustainability due to a lack of sufficient financial knowledge. The tourism sector SMEs were chosen for this research. Such SMEs highly depend on intangible assets and the influence of financial literacy particularly in the off-season. Results reveal that FL has positively influenced SMEs' sustainability, both directly and indirectly, by improving financial management techniques, specifically, financial management variate partial mediation. The findings it is also highlight the necessity of focused financial literacy programs, and training sessions, and contribute to existing literature on SME growth by indicating how financial literacy can increase firm sustainability in underdeveloped nations.

Keywords: Financial Literacy, SME Sustainability, Financial Management, Structural Equation Modeling, Entrepreneurship Development.

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Small and medium enterprises' viability and sustainability are measured through financial literacy, with an emphasis on the mediating effect of methods of managing finances. Mostly SMEs across the sector struggle with sustainability due to a lack of sufficient financial knowledge. The tourism sector SMEs were chosen for this research. Such SMEs highly depend on intangible assets and the influence of financial literacy particularly in the off-season. Results reveal that FL has positively influenced SMEs' sustainability, both directly and indirectly, by improving financial management techniques, specifically, financial management variate partial mediation. The findings it is also highlight the necessity of focused financial literacy programs, and training sessions, and contribute to existing literature on SME growth by indicating how financial literacy can increase firm sustainability in underdeveloped nations.

Keywords: [Financial Literacy](#), [SME Sustainability](#), [Financial Management](#), [Structural Equation Modeling](#), [Entrepreneurship Development](#)

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Introduction

The impact of economic growth is often seen because of the development of small businesses across the world both in developed and under-developing economies. In developing economies, small and medium enterprises (SMEs) are often seen to have an impact on economic growth, innovation, and job creation (OECD, [2023](#)), while financial management issues are a major factor in business failure (Babajide et al [2021](#)). SMEs still encounter significant challenges in achieving long-term sustainability. Financial literacy has been revealed as a capability that influences the

ability of firms or managers to make sound decisions related to financial management and allocate resources effectively, and efficiently to deal with financial complexities in a competent manner (Lusardi & Mitchell, [2014](#); Murendo & Mutsonziwa [2016](#)). Additionally, financial management practices establish a significant operational link between financial literacy and SME performance. A strong financial management system can convert financial knowledge into tangible and marketable outcomes through budgeting, forecasting, and financial analysis (Morshed, A. [2020](#); McMahan, [2001](#)). Without



effective financial management, even financially literate, they may fail to sustain and grow their businesses.

However, despite the increasing scholarly attention, gaps remain in understanding the mechanisms through which financial literacy translates into sustainable SME performance, particularly in developing economies where formal financial education opportunities are limited (Utomo, Cahyaningrum, & Kaujan, 2021). Moreover, prior research has often overlooked the mediating role of financial management practices, focusing instead on direct effects.

Against this backdrop, the current research seeks to determine how financial literacy affects the long-term viability of small and medium-sized businesses with a particular emphasis on the mediating role of financial management practices. By addressing this gap, the study provides theoretical contributions to the entrepreneurship and finance literature and offers practical insights for policymakers, development agencies, and SME owners seeking to foster resilience and long-term success.

To investigate the long-term assistance of FL for SMEs, with the mediation effect of various financial management methods.

The study's research questions are:

1. How do the managers and owners of the SMEs in Pakistan perceive and apply FL in their business practices?
2. What is the role of financial management methods in the long-term success of SMEs and the application of FL?

This research is aimed at:

- Explore how does financial literacy of owners and managers supports the success of Pakistani SMEs.
- Assess the mediator function of financial management in connecting FL Sustainability in the SMEs.

Review of Related Literature:

Financial Literacy and Sustainability in SMEs

Financial literacy is a major contributor influencing small business viability and sustainability. To comprehend and instrument the financial perceptions abilities like saving, budgeting, debt management, investing, and sensible spending strategies is known as financial literacy. It empowers organizations to plan and sustain their growth, make informed financial decisions, and allocate resources effectively. Furthermore, financial management techniques create

an operational connection between financial literacy and SME performance. For instance, Ye & Kulathunga (2019) found that higher FL significantly improves financial planning and access to credit, both of which are major contributors to SME sustainability. Likewise, Mireku, Appiah, & Agana (2023) showed that SMEs with financially literate owners demonstrate better financial management techniques and more flexibility to economic risk increasing their long-term sustainability. Financial literacy becomes expressly important in developing countries where formal financial education prospects are sometimes limited. Gora and Dahiya (2022) claim that one of the main reasons for SME failures in developing countries is insufficient financial literacy. Consequently, enhancing financial literacy not only helps in growth but also generates a strategic barrier to organizational sustainability.

Financial Management Practices as a Mediator

Planning, organizing, directing, and managing financial activities, including resource acquisition and utilization are all parts of financial management. (McMahon, 2001). Effective financial management for SMEs includes sound budgeting, cash flow management, financial forecasting, and record-keeping which are key factors to ensure operational efficiency and sustainability. A strong theoretical foundation suggests that financial literacy improves financial management practices, leading to stronger stability (Fatoki & Oni, 2014). Entrepreneurs with higher financial literacy anticipate effective control over financial matters, monitor expenses, and maintain financial records, which contribute to better decision-making and business resilience. Empirical studies support this mediation framework. For example, Zada, Yukun, and Zada (2021) revealed that SMEs with better financial management practices had higher rates of profitability, business continuity, and market expansion. Furthermore, Dakare and Okon (2021) found that the connection between financial literacy and business accomplishments is partially due to practices in financial management, indicating that having financial knowledge alone is not sufficient without practicing it.

Thus, financial management practices serve as a thoughtful operational mechanism through which financial literacy translates into tangible sustainability outcomes for SMEs.

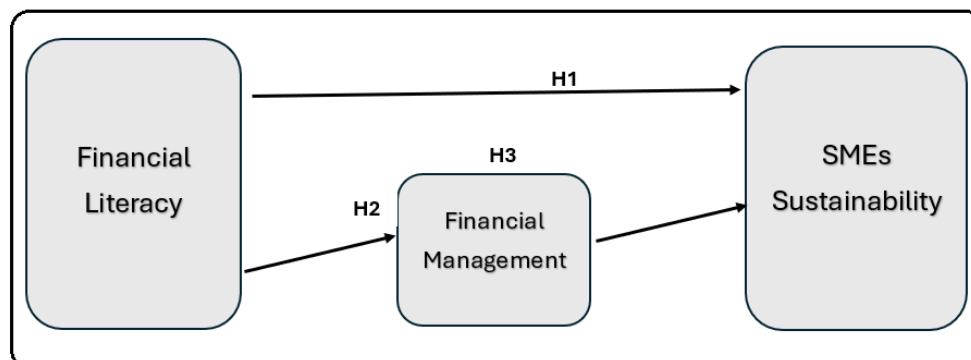
Conceptual Framework Development

Financial literacy is conceptualized as an intangible

resource that gives a firm a competitive edge when it is successfully used through sound financial management practices, based on the resource-based perspective (RBV) of the business (Putra et al., 2021, Barney, 1991, Wernerfelt, 1984). This study posits that

FL poses both the effects on sustainability of SMEs directly and indirectly, with financial management methods playing a key role as a mediating mechanism, according to this theoretical framework.

Figure 1



Based on the literature, the following hypotheses were developed:

H1: Financial literacy has positive impacts on the SME's sustainability.

H2: There is a strong correlation between financial literacy and efficient financial management practices

H3: The use of financial management practices has a positive impact on the sustainability of small and medium-sized enterprises.

H4: The functions of financial management act as a link between financial literacy and the sustainability of SMEs.

Research Design

The intention of the survey was to inspect the long-term sustainability of SMEs through quantitative research, with an emphasis on FL and the role of functions of financial management in mediating the effect. Primary data was gathered from varied clusters of SME owners and managers from the hospitality and tourism sectors at a single point in time. The hospitality and tourism industry is one of the most significant and important contributors to economic growth, and job creation, and is considered most exposed to sustainable development globally. In the tourism industry, small and medium-sized businesses (SMEs) are imitated as a dynamic component of the local economy, making them a key subject for research on sustainable performance and FL (Akomea et al., 2023; Kabir & Bari, 2023; Hussain & Khan, 2019). Moreover, small and medium-sized businesses frequently struggle with fluctuating demand, seasonal

income variations, and high operational expenses. Their capacity to manage cash flow, obtain finance, and reduce financial risks is directly affected by FL. The analysis of such SMEs offers valuable insights into how financial literacy translates into long-term success. Additionally, in order to ensure long-term sustainable performance during off-peak times, these SMEs require a formal financial management system. The quantitative method was thought to be appropriate for conceptualizing the interaction of the variables because the aim of this research was to investigate the long-term viability of SMEs through quantitative research, with an emphasis on financial literacy and the moderating role of financial management practices.

Population and Sample

Population, as defined by researchers, includes any society or group that has the same features for a given study (Bell & Bougy, 2022; Sekaran & Bougy, 2016). The population of this study comprised all individuals who own or manage SMEs in the tourism industries of Khyber Pakhtunkhwa Province, Pakistan. In KP, according to the data provided by the Pakistan Tourism Development Corporation, 2022 (PTDC), there are two thousand ten (2010) tour operation businesses, eleven hundred seven (1107) hotel businesses, and three hundred (3000) operating restaurants listed (Pakistan Tourists Development Corporation, 2022). Thus, this research includes six thousand one hundred and seventeen (6,117) small and medium-sized enterprises that are involved in the tourism and hospitality industry in KP.

For the population size of 6117, the researcher in this study employed the well-known Krejcie and Morgan (1970) equation for determining sample size with 95% confidence intervals. A significant challenge for researchers in the social sciences, according to Bell et al. (2022) and Taherdoost (2016), is the low response rate caused by voluntary involvement. The literature recommends oversampling 40–50% of the real sample size in order to address this issue (Bell et al., 2022; Rijnhart et al., 2021; Abu-Bader & Jones, 2021; Sekaran & Bougie, 2016). Therefore, the real sample size for this study was 361, and an extra 40% was included, bringing the total sample size to around 405 (361+144=405).

Data Collection Procedure

The strata were classified for analysis in order to establish three separate categories: restaurants, tour guides, and hotels. For data collection, systematic random sampling was used to determine each layer in proportion based on the figure of the businesses functioning in all groups inside the strata. Hence, a systematic approach to random sampling is used, the study surveys were distributed among these SMEs, selecting every 15th within each stratum. Follow-up reminders greatly increased participation, for the initial low response rate. In the end, we gathered comprehensive surveys from 337 SMEs, including 147 restaurants, 67 hotels, and 123 tour operators.

Instrumentation

The questionnaire was developed based on established scales from previous research, with minor modifications to fit the SME context in Pakistan. Financial literacy was assessed using a revised version of the scale created by Lusardi and Mitchell (2014) and modified by Fatoki (2014). It included items assessing the impact of basic financial management perceptions and the capability of applications in business decisions. Financial management practices are assessed using items adapted from previous studies (e.g., McMahon, 2001), including themes like cash flow management, financial planning, and budgeting. And financial record keeping. SMEs sustainability is measured using a modified version of the sustainability scale developed by Agyapong (2010) and recently by Somathilake and Pathirawasam, (2020) focusing on dimensions such as business continuity, profitability,

market share growth, and adaptability. On a Likert scale of five points ranging representing one for "Strongly Disagree" and up to five, five representing "Strongly Agree", all constructs were assessed. On 30 SME owners. To validate the instrument, an experimental test was conducted to measure the consistency and precision of the questionnaire objects. Based on the pilot results, minor adjustments were made to the wording for improved comprehension.

Analysis

SPSS was used to analyze the collected data for descriptive statistics and initial tests (normality, reliability, and correlations), while AMOS was used for Structural Equation Modeling (SEM) and Confirmatory Factor Analysis (CFA). Internal consistency was assessed using Cronbach's alpha, while CFA confirmed construct validity (convergent and discriminant validity). SEM was applied to examine the relationships among the defined variables, assess model fit and evaluate mediation effects through bootstrapping methods with 5,000 resamples.

Results and Analysis

The data obtained from SME owners and managers was analyzed with Structural Equation Modeling (SEM) to evaluate the hypotheses. The measurement model reliability and validity were tested through a confirmatory factor analysis (CFA). Descriptive statistics reveal that respondents demonstrated moderately positive perceptions across all measured variables, with a mean value from 3.10 to 3.25 range on a 5-point Likert scale. The value for standard deviations, from 0.590 to 0.808 range suggests a moderate spread of responses, with *Financial Management* showing the least variability and *Sustainability* the most. Reliability analysis using Cronbach's Alpha shows strong internal consistency for all constructs, having a value that is higher than the acceptable range of 0.70. The greater greatest reliability was found for *Sustainability* ($\alpha = 0.830$), indicating that the items used to measure these constructs were consistently interpreted by respondents. Overall, the data indicates reliable measurement instruments and a generally positive trend in perceptions across all financial and sustainability-related dimensions.

Table 1*Descriptive data statistics*

Particular	Financial Literacy	Financial Management	Sustainability
Mean	3.10	3.15	3.25
SD	0.590	0.590	0.808
Cronbach Alpha	0.793	0.785	0.83

Inter construct correlation

The study used the Pearson correlation coefficient to explore the relationships among variables. The range of values demonstrates the degree of correlation between the variables, which is between -1 and 1 for this test. A value near one shows a strong link between variables, while values far from one suggest a weak correlation. A recommended range is between -0.3 to

0.7 for social sciences. In examining the correlation among financial literacy, financial management, and sustainability, the study accounted for demographic factors i.e. education level, age group, gender, and type of organization. The results indicated all variables are positively correlated and statistically significant, with no signs of multicollinearity observed.

Table 2*Inter construct correlation*

Variables	Financial Literacy	Financial Management	Sustainability
Financial Literacy	1	0.475**	0.342**
Financial Management	0.475**	1	0.443**
Sustainability	0.342**	0.443**	1

The validity of the construct FL was examined using factor loading in SPSS; all the items were over the threshold of 0.7, therefore indicating a strong correlation. Found to be 0.524, the AVE, explains how much variance is constructed in its indicator, thereby means more than half the variation by the construct explained it. Additionally, confirming the internal consistency of the construct, composite reliability (CR) for FL was measured at 0.916, far over the acceptable limit of 0.7. The results are also confirmed in earlier studies like Hamid et al., (2017), Bell et al., (2022), and Rönkkö and Cho, (2022).

Financial management was split into four categories: capital budgeting, capital structure and finance, AIS (Accounting Information Systems),

and WCM (Working Capital Management). The discriminant validity of financial management employing factor loadings, AVE (Average Variance Extracted), and CR (Composite Reliability). The WCM's factor loadings were higher than 0.7, indicating a significant association and its AVE was 0.502, proving that the variable accounts for more than half of the variation. At 0.751, its CR indicated good reliability. With an AVE is 0.505 and a CR of 0.897. The AIS demonstrated acceptable factor loadings, for capital structure and funding, the factor loadings, AVE of 0.515, and CR of 0.896 confirmed reliabilities. Lastly, the capital budgeting feature confirmed its validity by having satisfactory factor loadings with an AVE of 0.502 and a CR of 0.840.

Table 3*Discriminant Validity of Financial Management*

FM Functions	AVE	Composite Reliability
W C M	0.502229	0.751386
A I S	0.505781	0.897067
C S F	0.515041	0.896046
C B	0.502575	0.840594

We examined the discriminant validity of the sustainability construct and found that there were significant factor loadings, suggesting a strong correlation with the variables. The construct for more than 50% of the variance in items, as

evidenced by an AVE (Average Variance Extracted) of 0.501. In addition, a CR (Composite Reliability) value of 0.889 validates the consistency and reliability of the measures.

Measurement Model Assessment

The measurement model fit had indicated satisfactory results, as evidenced by a CFI (Comparative Fit Index) value of 0.92, a RMSEA (Root Mean Square Error of approximation) of 0.05, and a SRMR (Standardized Root Mean Square Residual) value of 0.04, indicating an acceptable model fit. The reliability is demonstrated of all

constructs and shows excellent values with Cronbach's alpha value above 0.80 and CR (Composite Reliability) values above 0.85. Convergent validity was further supported by the AVE (Average Variance Extracted) for all the constructs and was found beyond the established edge of 0.50. Discriminant validity was also evaluated using the Fornell-Larcker criterion.

Table 4

Summary of Model Fit

Index	CFI	RMSEA	SRMR	χ^2/df
Edge	>0.90	<0.08	<0.08	3.00
Ratio	0.92	0.05	0.04	2.31

Research Hypothesis and Structural Model

The structural model was used to evaluate the anticipated links between FL, sustainability, and financial management methods in the SMEs. The main findings are:

H1: Financial literacy has positive impacts on the SME's sustainability.

Financial literacy was found to be significantly correlated with the SMEs' sustainability ($\beta = 0.41$, $p < 0.001$). According to this, improved financial literacy among SME owners is correlated with greater firms' sustainability, profitability, and resilience.

H2: Financial literacy positively affects financial management practices:

It was demonstrated that financial literacy has a major positive influence on financial management practices ($\beta=0.59$, $p<0.001$). This outcome suggests that owners/managers with financial literacy are more inclined to plan budgets, manage finances, manage cash flow, and produce financial reports.

H3: The use of financial management practices has a positive impact on the sustainability of small and medium-sized enterprises.

According to financial management practices, the results show a substantial valuable impact on SME sustainability ($\beta = 0.46$, $p < 0.001$), SMEs that consistently utilized these strategies were more successful in maintaining operational stability and strategic expansion.

H4: The functions of financial management act as a link between financial literacy and the sustainability of SMEs.

Mediation analysis based on the bootstrapping approach showed that financial management practices mediate the connection between SME

sustainability and financial literacy. The direct effect remained significant, while the indirect effect was considerable ($\beta=0.27$, $p<0.001$), suggesting partial mediation. Though financial literacy directly affects SME sustainability, a substantial part of its effect is funneled through better financial management practices, indicating in the findings.

Discussion

The results of this study provide empirical evidence for the significance of financial literacy and financial management techniques in enhancing the sustainability of small and medium-sized businesses. Specifically, the data demonstrates that financial literacy has a direct, positive, and substantial impact on the sustainability of small and medium-sized enterprises. This implies that SMEs with more financial literacy are better equipped to make wise decisions and manage resources effectively and efficiently, leading to the long-term survival of their organization.

Moreover, the study confirms that financial literacy helps to implement financial management techniques in SMEs. SME owners and managers with higher levels of financial literacy show a stronger tendency to participate in formal financial planning, budgeting, financial performance monitoring, and wise investment decisions. These apply improved SME sustainability considerably and emphasize financial management's operational practice.

The mediation study shows that SMEs' sustainability and financial knowledge were partly mediated by financial management techniques. This means that financial literacy directly supports sustainability, a substantial portion of its impact is realized through financial management. This finding aligns with and extends prior studies (e.g., Owusu et

al., 2019; Nkundabanyanga, et al. 2015), which suggests that the practical application of financial knowledge through systematic financial management is a key mechanism by which SMEs achieve resilience and long-term sustainability.

Confirmation of financial management as a mediator counts theoretical value to the study. Consistent with the framework of RBV (Resource-Based View) as stated by Barney (2000), results suggest that financial literacy (an intangible resource) must be operationalized through organizational routines (financial management practices) to create sustainable competitive advantage. Simply possessing financial knowledge is not enough; it must be actively applied in the firm's day-to-day operations.

From a practical perspective, the study highlights that efforts to improve SME sustainability should not only focus on increasing entrepreneurs' financial literacy but also on strengthening their financial management capabilities. Training programs, advisory services, and financial education curricula should therefore integrate both financial knowledge and practical skills related to financial management.

Furthermore, the findings are particularly relevant in today's volatile economic environment, where SMEs must be agile, financially sound, and strategically managed to survive. Entrepreneurs who combine financial literacy with strong management practices are better equipped to navigate financial challenges, exploit opportunities, and maintain operational stability.

In comparison with earlier research, this study reaffirms the conclusions of Arsawan et al., (2022) and Abbas et al., (2020) who stressed the equal significance of knowledge and application for the expansion and viability of small and medium-sized businesses. However, by empirically validating the mediating role of financial management in the Pakistani SME context, the study adds new insights to the existing literature and provides region-specific evidence that can inform policy and practice.

In summary, the study underscores that enhancing SME sustainability requires a dual focus: improving financial literacy and ensuring the practical application of that knowledge through systematic financial management practices. Strengthening both dimensions will lead to more resilient, profitable, and sustainable small businesses.

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