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Assessing financial health in small businesses: a structural equation modeling study

Evaluación de la salud financiera en pequeñas empresas: un estudio de modelado de ecuaciones estructurales

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Resumen

La evaluación de la salud financiera de las pequeñas empresas es un proceso crucial pero desafiante que afecta la sostenibilidad, el rendimiento y la toma de decisiones. En este estudio, el modelo de ecuaciones estructurales (SEM, por sus siglas en inglés) se utiliza para analizar los diferentes aspectos que afectan la salud financiera de las pequeñas empresas. Examinamos las interacciones entre las métricas financieras, la eficacia operativa, los enfoques de gestión estratégica y las variables ambientales externas utilizando un gran conjunto de datos de pequeñas empresas. Nuestros hallazgos ilustran la compleja red de factores sobre la salud financiera al revelar fuertes conexiones entre estas dimensiones latentes. El marco SEM facilita la estimación de los impactos relativos de las variables al iluminar sus interacciones directas e indirectas. El estudio también arroja luz sobre las dificultades particulares a las que se enfrentan las pequeñas empresas y la necesidad de una evaluación financiera especializada.

Palabras clave: Salud financiera, Pequeña empresa y SEM

Abstract

Small business financial health evaluation is a crucial yet challenging process that affects sustainability, performance, and decision-making. In this study, structural equation modeling (SEM) is used to look at the many different aspects that affect small enterprises' financial health. We examine the interactions between financial metrics, operational effectiveness, strategic management approaches, and external environmental variables using a large dataset of small businesses. Our findings illustrate the complex web of factors on financial health by revealing strong connections between these latent dimensions. The SEM framework facilitates in estimating the relative impacts of the variables by illuminating their direct and indirect interactions. The study also sheds light on the particular difficulties encountered by small enterprises and the need of specialized financial evaluation.

Keywords: Financial health, Small business and SEM

Introduction

Small companies are essential for supporting innovation, job creation, and economic progress. However, their capacity to have strong financial health is essential to their existence and success. A complex interaction of internal and external factors influences the challenging task of evaluating the financial health of small firms. For educated decision-making, strategic planning, and long-term growth, it is essential to comprehend these aspects and how they interact.

Small business financial health is evaluated by looking at a number of factors, such as liquidity, solvency, profitability, and efficiency. Traditional financial ratios provide useful information, but because of their concentration, they frequently give an inaccurate image. Small firms work in dynamic contexts where elements like changes in the market, alterations in the law, and advances in technology have an influence on their capacity to make money. As a result, a holistic approach that considers both financial and non-financial variables is essential.

The sophisticated framework offered by structural equation modeling (SEM) enables a thorough examination of the complex interrelationships between the various factors influencing financial well-being. The examination of direct and indirect impacts is made possible by SEM's integration of latent constructs and observable indicators, which reveals intricate patterns of influence. SEM provides the chance to quantify the contributions of many aspects in the context of evaluating the financial health of small enterprises, allowing for a greater comprehension of their relative importance.

Review of the Literature

Financial Health Assessment plays a crucial role in predicting company sustainability and performance, the measurement of financial health in small enterprises has attracted significant attention in the literature (Smith et al., 2018). The multidimensional approach is essential to fully assess the financial health of small firms, academics have argued for a multidimensional approach that goes beyond conventional financial ratios and incorporates both financial and non-financial variables (Pandey, 2019).

The operational efficiency according to Gupta and Chauhan (2017), operational efficiency measures including asset turnover, working capital management, and inventory turnover are important indicators of the financial health of small enterprises. The strategic management literature investigates the crucial roles that strategic management choices, cost-cutting measures, and innovation tactics play in determining the financial stability of small businesses (Davidsson, 2016). The external factors are the variables have been identified as influencing the financial health outcomes of small enterprises, including industry developments, competitive dynamics, and economic situations (Wu et al., 2020).

The structural equation modelling will enable better comprehend the linkages between the numerous aspects impacting financial health and their complicated interactions, structural equation modeling (SEM) is recognized as a potent analytical technique (Kline, 2015). The financial ratios are the indicators for assessing the financial health of small enterprises include specific financial ratios including the current ratio, debt-to-equity ratio, and return on assets (Altman, 1968).

The operational metrics are essential when assessing the liquidity and productivity of small firms, researchers have underlined the significance of operational measures such inventory turnover, accounts receivable turnover, and cash conversion cycle (Gujarati & Sangeetha, 2019). The impact of debt is the financial health and risk profile of small enterprises can be strongly impacted by the structure of debt and leverage, according to research (Ooghe & De Prijcker, 2013).

The sustainability is emphasized by academics that solid financial health is essential for long-term sustainability of small firms and that these two factors are intertwined (Li et al., 2017). The resource allocation according to research, efficient resource allocation, which includes wise investment choices and cost management, may significantly improve the financial health of small enterprises (Mehran et al., 2018). The Studies have highlighted the interdependence of innovation strategies, growth ambitions, and financial health in small enterprises (Wiklund & Shepherd, 2003).

The cash flow analysis according to (Dowling & Lucey, 2005) emphasizes the importance of cash flow analysis as a tool for evaluating liquidity and financial health in small firms. The industry variability is the affect the financial dynamics of small enterprises, researchers agree that financial health evaluation requires to take industry-specific subtleties and risk profiles into account (Weaver & Dickson, 1998). The Studies explore the impacts of outside funding sources, such as bank loans, angel investments, and venture capital, on the financial stability and expansion possibilities of small enterprises (Colombo et al., 2019).

Statement of the problema

Small firms have a crucial role in economies by fostering innovation, employment, and economic expansion. However, their financial situation is frequently fragile, which affects their viability and capacity to overcome obstacles. Traditional financial ratios provide information, but they only give a partial picture of the complex variables impacting financial health. Studies already conducted frequently lack a thorough framework to evaluate the complex interactions between financial indicators, operational effectiveness, strategic strategies, and outside influences. This study examines how these elements jointly affect the financial health of small enterprises in order to address the need for a comprehensive strategy. The challenge is in comprehending the intricate connections between these factors and measuring their respective contributions to enable customized solutions to improve small business sustainability and financial well-being.

Objectives of the study

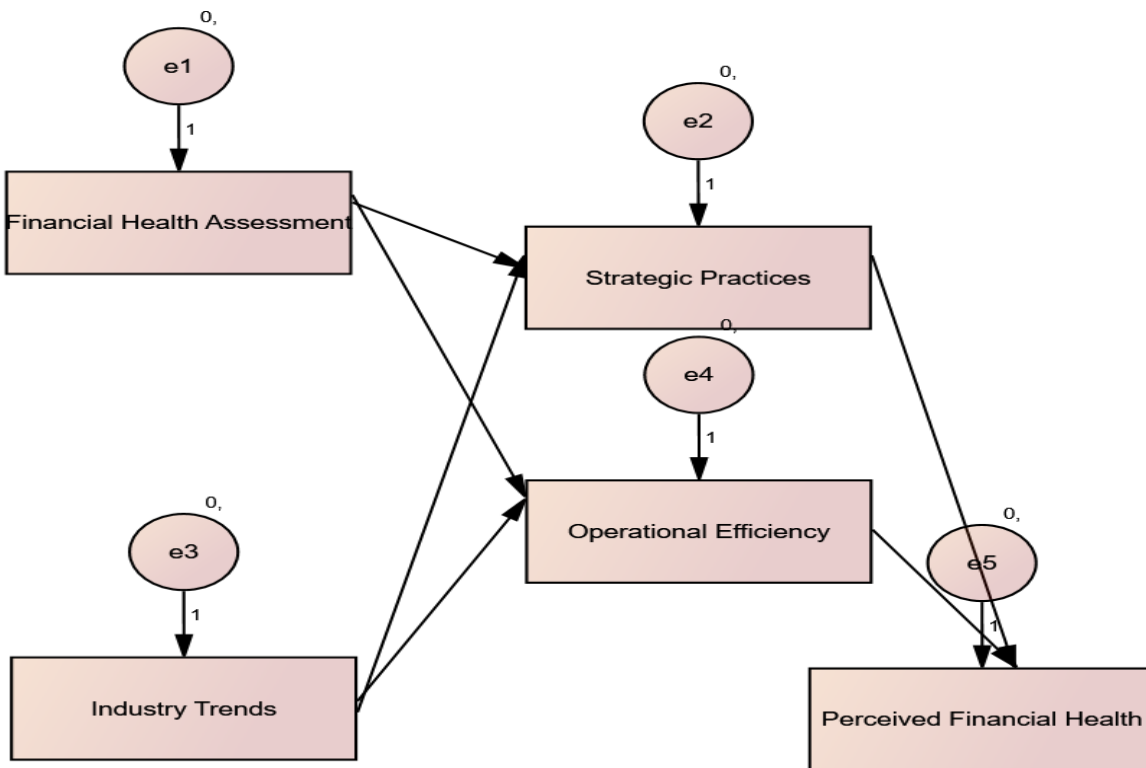
- To develop a thorough collection of important financial indicators that includes liquidity, solvency, profitability, and operational effectiveness to give a comprehensive picture of the financial health of small firms.
- To examine how the financial stability of small firms is affected by operational efficiency measures like inventory turnover and asset use.

- To consider how strategic management techniques, such as cost management and resource allocation, affect the monetary health of small businesses.

- To examine how external variables such as market circumstances and legislative changes affect the financial stability of small firms.

The Conceptual Framework

Figure 1: Impact of financial health assessment and industrial trends on perceived financial health based on strategic practices and operational efficiency



With the conceptual framework, the dimension's financial health assessment and industry trends are considered to be independent variables, the dimension's strategic practices and operational efficiency are considered to be mediating variables and the dimension perceived financial health is considered to be dependent variable.

The Financial Health Assessment (FHA) refers to the various tools, measurements, and procedures employed by firms to evaluate their financial well-being. Illustrative instances could encompass liquidity ratios, solvency ratios, profitability ratios, and so forth.

The subject of interest pertains to the industry trends within the realm of Industry Trends (IT), specifically focusing on the external variables that exert influence on enterprises operating within a certain industry. Potential factors that may influence business operations encompass technical improvements, consumer preferences, market demands, and regulatory changes, among others.

Strategic Practices (SP) refer to the actions or strategies that businesses employ at a macro level, including but not limited to mergers and acquisitions, market expansions, and diversifications.

Operational Efficiency (OE) refers to the implementation of specific strategies or approaches at a granular level, aimed at enhancing operational performance. These strategies may encompass several initiatives, including process optimization, cost reduction measures, and the adoption of lean management practices.

Perceived Financial Health (PFH) refers to the subjective evaluation of a company's financial health and future prospects. This assessment is typically impacted by a combination of internal financial indicators and external perceptions.

Scope of the study

The goal of this study, "Assessing Financial Health in Small Businesses: A Structural Equation Modelling Study," is to thoroughly examine the financial health assessment procedure as it relates to small enterprises. The study uses a structural equation modelling (SEM) technique for a thorough analysis in order to analyze the numerous aspects and indicators that determine the financial health of small enterprises. The study's main

objective is to pinpoint the crucial financial measures, ratios, and qualitative factors that are essential for evaluating the financial stability of small firms.

The study investigates the distinct possibilities and difficulties that small enterprises confront in various situations across a wide variety of sectors and geographical areas. It explores the connections between financial metrics and their bearing on the performance, sustainability, and potential for growth of the entire firm. The study seeks to provide a thorough framework that captures the complex interdependencies between various financial factors through the use of SEM.

Materials and Methods

1. **Research Design:** Structural Equation Modeling (SEM), a quantitative research methodology, is used in this study to examine how small enterprises might analyze their financial health. In order to comprehend the linkages between financial indicators, operational effectiveness, strategic practices, and external influences, the study design include gathering and evaluating data.

2. **Data Collection:** Structured questionnaires sent to a varied sample of small company managers and owners is used to gather primary data. Financial ratios, operational indicators, strategy choices, and external environmental elements all be included in the survey. Electronic data collecting is used to increase accessibility and response rates.

3. **Sample Selection:** A representative sample of small enterprises from different industries and geographical areas is what the study strives at. To make sure that there is a balanced representation, sampling techniques such stratified random sampling is used. Statistical power analysis is used to establish the sample size.

4. **Variables and Measurements:** Both independent (financial indicators, operational effectiveness, strategic practices, and external influences) and dependent (financial health) variables is included in the study. Participants' perceptions and factual information is evaluated using measurement measures, such as Likert scales and financial ratios.

5. Structural Equation Modeling (SEM): SEM is the primary analytical method used. It enables the investigation of both direct and indirect links between observable variables and latent components. Theoretical frameworks are used to create the proposed model, which then be improved using statistical fit indices.

6. Data Analysis: Data collection is thoroughly cleaned, validated, and transformed as necessary. Utilizing specialist software, descriptive statistics, correlation analysis, and SEM approaches is used. Model fit indices (such as Chi-square, RMSEA, and CFI) is used to evaluate the SEM's suitability.

7. Tools for analysis: Percentage analysis, Descriptive statistics, oneway ANOVA and SEM analysis.

8. Ethical Considerations: The use of human beings in research shall rigorously abide by ethical standards. Participants is asked to give their informed consent, and replies is kept secret.

9. Limitations and Assumptions: Potential drawbacks such sample bias, self-reported data, and model assumptions are acknowledged by the research. The results are interpreted in light of these constraints.

10. Practical Implications: The study's findings offer small company owners, decision-makers, and stakeholders new information. The SEM results is used to provide suggestions and tactics for boosting financial health and sustainability.

11. Contribution and Dissemination: This study adds to our knowledge of how to evaluate the financial health of small firms and how to use SEM in this setting. To the advantage of academia and industry, the results is disseminated through academic journals, conferences, and other appropriate venues.

Limitations of the study

It's crucial to recognize the limits of this study, though. The size and makeup of the sample may have an impact on the results, thereby restricting their applicability to a larger population. Furthermore, the study's dependence on publicly available data might result in missing or inaccurate data. Although structural equation modeling sheds light on the connections between variables, it cannot prove that one thing caused another. The results might be affected by the model parameters that were used, and the study's scope could not include all external elements affecting financial wellness. Despite these drawbacks, the study provides insightful information on evaluating the financial health of small enterprises, laying the groundwork for future research and specialized approaches.

Result and discussion

Table 1: Demographic variables of the respondents

Demographic variables	Particulars	Frequency	Percent
Gender	Male	58	38.7
	Female	92	61.3
	Total	150	100.0
Age	Under 18 years	25	16.7
	18-24 years	38	25.3
	25-34 years	27	18.0
	35-44 years	51	34.0
	45 and above	9	6.0
	Total	150	100.0
Industry Sector	Finance	7	4.7
	Manufacturing	8	5.3
	Technology	37	24.7
	Healthcare	68	45.3
	Other	30	20.0
	Total	150	100.0

Gender: The findings show that the respondents to the survey had a fairly equal mix of genders. 150 people responded, and of them, 38.7% identified as men and 61.3% as women. This distribution shows that the sample has a good balance between the two genders.

Age: The age distribution of the responders shows a wide variety. The age group that makes up the biggest portion of the sample, at 34.0%, is 35 to 44 years old. The second-largest demographic, comprising 25.3% of responses, is between the ages of 18 and 24. Less people fall into the other age groups, which include those between the ages of 18 and 44 (6.0%), 25 to 34 (18.0%), and above the age of 45 (16.7%). With a sizable fraction in the mid-range age group, this distribution indicates a well-balanced distribution throughout the major age categories.

Industry Sector: The respondents are employed in a range of business sectors, with noteworthy specializations in technology and healthcare. The largest category consists of workers in the healthcare industry (45.3%), followed by workers in the technology sector (24.7%). At 5.3% and 4.7%, respectively, the manufacturing and finance industries have lower representations. Furthermore, 20.0% of respondents work in different industrial areas. This shows that the sample is primarily made up of people with backgrounds in technology and healthcare, demonstrating a wide range of professional backgrounds.

Figure 2: Demographic variables of the respondents

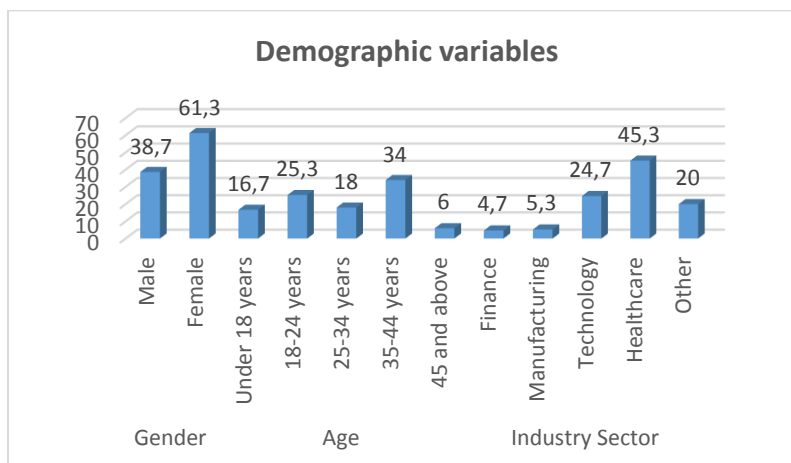


Table 2: Descriptive Statistics for Operational Efficiency

	N	Mean	Std. Deviation
Asset Turnover	150	2.42	1.233
Working Capital Management	150	3.37	1.398
Inventory Turnover	150	2.91	1.131
Valid N (listwise)	150		

Inventory turnover (2.91) and asset turnover (2.42) are crucial for operational effectiveness. Working capital management (3.37) is not particularly significant in determining operational effectiveness.

Figure 3: Operational Efficiency

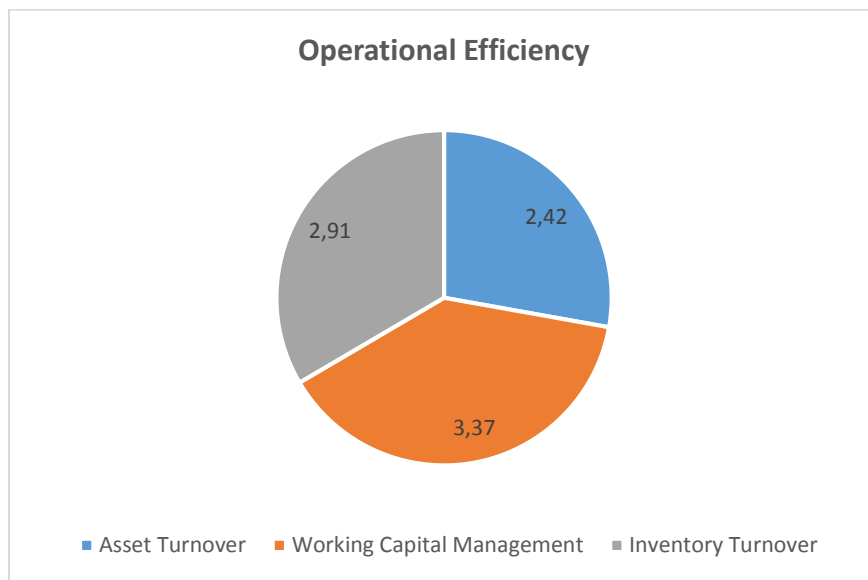


Table 3: Comparison between age of the respondents and efficiency of the respondents

Ho1: Significant difference exists between age of the respondents and efficiency of the respondents

	Age of the respondents	N	Mean	SD	F	Sig
Financial Health Assessment	Under 18 years	25	2.88	0.939	0.418	0.796
	18-24 years	38	2.74	0.891		
	25-34 years	27	2.89	0.847		
	35-44 years	51	2.85	1.226		
	45 and above	9	3.22	1.176		
	Total	150	2.86	1.027		
Operational Efficiency	Under 18 years	25	2.6	1.081	2.526	0.018
	18-24 years	38	2.72	0.995		
	25-34 years	27	3.15	0.824		
	35-44 years	51	3.02	1.035		
	45 and above	9	3.08	1.14		
	Total	150	2.9	1.011		
Strategic Practices	Under 18 years	25	2.68	0.988	0.694	0.597
	18-24 years	38	2.89	1.198		
	25-34 years	27	3.11	1.077		
	35-44 years	51	2.87	1.095		
	45 and above	9	2.56	1.13		
	Total	150	2.87	1.1		
External Factors	Under 18 years	25	2.66	1.077	2.176	0.075
	18-24 years	38	2.91	0.972		
	25-34 years	27	3.35	1.142		
	35-44 years	51	3.25	1.031		
	45 and above	9	3.28	0.755		
	Total	150	3.08	1.048		
Perceived Financial Health	Under 18 years	25	2.42	0.886	1.482	0.211
	18-24 years	38	2.71	1.178		
	25-34 years	27	3.15	1.09		
	35-44 years	51	2.75	1.102		
	45 and above	9	2.78	1.176		
	Total	150	2.76	1.099		

The table gives details on numerous evaluation criteria across various responder age groups. Among the variables are "Financial Health Assessment," "Operational Efficiency," "Strategic Practices," "External Factors," and "Perceived Financial Health." The table includes the mean, standard deviation, F-value, and significance level (Sig) for each age group for each component that was evaluated on a scale.

Financial Health Assessment: Across all age groups, the mean financial health evaluation scores range from 2.56 to 3.22. The difference in mean scores across age groups is not noteworthy, since the F-value is not statistically significant (Sig =.796). This shows that the respondents' perceived financial health evaluation is not much impacted by their age.

Operational Efficiency: Across different age groups, the mean ratings for operational efficiency range from 2.60 to 3.15. The F-value is statistically significant (Sig =.018), indicating that the mean scores for the various age groups differ significantly from one another. This suggests that respondents' ages may affect how effectively they view their operational efficiency, as certain age groups had greater mean ratings than others.

Strategic Practices: Across age groups, the mean scores for strategic practices range from 2.56 to 3.11. The F-value is not statistically significant (Sig =.597), indicating that perceived strategic approaches are not substantially impacted by age. The variations in mean scores are not significant enough to be taken into account.

External Factors: Across age groups, the external factors assessment's mean scores range from 2.66 to 3.35. The F-value is getting close to statistical significance (Sig =.075), suggesting that there may be some effect of age on how external variables are perceived to have an impact. The pattern shows that older age groups may perceive external influences differently than younger age groups, albeit this is not statistically significantly significant.

Perceived Financial Health: Across all age categories, the mean ratings for perceived financial health vary from 2.42 to 3.15. The F-value is not statistically significant (Sig =.211), indicating that there is no real significance to the mean score differences across age groups. This suggests that respondents' perceptions of their financial health may not be much impacted by age.

Table 4: Structural Equation Modelling (SEM) Analysis

Impact of financial health assessment and industrial trends on perceived financial health based on strategic practices and operational efficiency

Results of goodness- of-fit test for model

Full Model	CMIN/DF	P	RMR	GFI	AGFI	IFI	CFI	RMSEA
Obtained value	3.125	0.000	0.623	0.956	0.963	0.795	0.901	0.052
Observed value	≤ 5	<.05	<1	>0.90	>0.90	0.7-1.0	0-1	<.08

The above table depicts that the CMIN/DF (3.125) is less than 5, p value (0.000) less than 0.05, RMR value (0.623) less than 1, GFI value (0.956) and the AGFI value is at (0.963), which is greater than 0.90, IFI value (0.795) between 0.7-1.0, CFI (0.901) between 0-1 and RMSEA value (.05) less than 0.08, so the entire model can proceed to find the impact of financial health assessment and industrial trends on perceived financial health based on strategic practices and operational efficiency.

Table 5: Co-efficient for impact of financial health assessment and industrial trends on perceived financial health based on strategic practices and operational efficiency

Dependent variables		Independent variables	Estimate	S.E.	C.R.	P	Result
Strategic Practices	<---	Financial Health Assessment	.347	.080	4.345	***	S
Strategic Practices	<---	Industry Trends	.200	.063	3.187	.001	S
Operational Efficiency	<---	Financial Health Assessment	.580	.064	9.049	***	S
Operational Efficiency	<---	Industry Trends	.082	.050	1.626	.004	S
Perceived Financial Health	<---	Operational Efficiency	.566	.080	7.065	***	S
Perceived Financial Health	<---	Strategic Practices	-.057	.074	-.778	.437	NS

Strategic Practices and Financial Health Assessment

For every unit increase in the Financial Health Assessment (while holding other variables constant), Strategic Practices increases by 0.347 units.

The Standard Error (S.E.) of 0.080 suggests that the estimate is precise.

The Critical Ratio (C.R.) of 4.345, which is a value greater than 1.96 (for a 95% confidence level), indicates that this relationship is statistically significant.

The 'P' value is denoted by '****', which implies a very low probability (typically less than 0.01) of observing such a relationship if it doesn't exist in the population. This further confirms its statistical significance.

Strategic Practices and Industry Trends

A unit increase in Industry Trends leads to a 0.200-unit increase in Strategic Practices. With a C.R. of 3.187 and a P value of 0.001, this relationship is statistically significant.

Operational Efficiency and Financial Health Assessment

A unit increase in Financial Health Assessment is associated with a substantial 0.580-unit increase in Operational Efficiency.

This relationship is very significant with a C.R. of 9.049 and a '****' P value.

Operational Efficiency and Industry Trends

There's a 0.082-unit increase in Operational Efficiency for every unit increase in Industry Trends.

Though smaller in magnitude compared to Financial Health Assessment, this relationship is still statistically significant (C.R. = 1.626 and P = 0.004).

Perceived Financial Health and Operational Efficiency

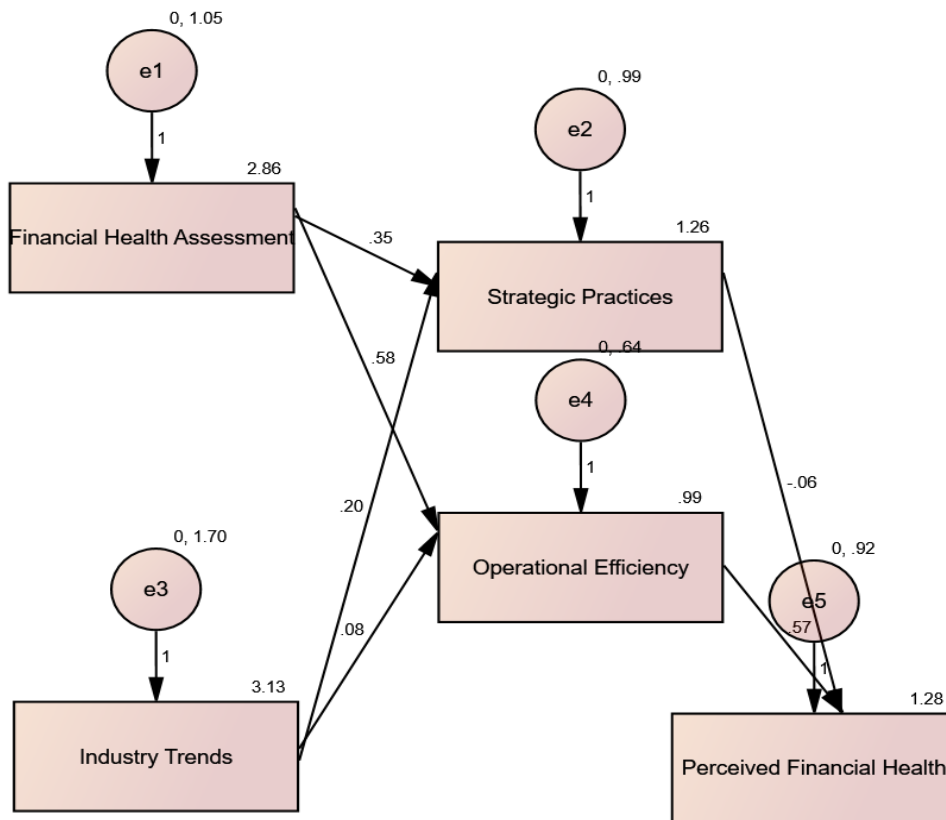
Operational Efficiency has a strong positive impact on Perceived Financial Health. A unit increase in Operational Efficiency leads to a 0.566-unit increase in Perceived Financial Health.

With a very high C.R. of 7.065 and a '****' P value, this relationship is highly statistically significant.

Perceived Financial Health and Strategic Practices

Interestingly, there's a slight negative relationship between Strategic Practices and Perceived Financial Health. However, this relationship is not statistically significant, as indicated by the C.R. of -0.778 and a P value of 0.437 (which is greater than 0.05).

Figure 4: Output towards the model



Findings

- These results offer insights into the demographics of the surveyed population, which can be used to better understand the characteristics of the sample in relation to the variables of gender, age, and industry sector.
- The survey encompasses a balanced gender distribution, a diverse age range with a significant proportion in the 35-44 years bracket, and a predominate representation from the healthcare and technology sectors in terms of industry.
- The interpretation suggests that the impact of age on various evaluation parameters may vary. While there are some age-related changes in operational effectiveness and external influences, assessments of financial health, strategic practices, and perceived financial health appear to be less affected by age.
- The statistical significance of these variations between age groups is revealed by the F-values and significance levels.
- The mean values give a sense of the average performance of the sample entities in these areas. The offered descriptive statistics offer insights into the operational efficiency indicators of asset turnover, working capital management, and inventory turnover.
- The standard deviations demonstrate how much variation there is around the mean and how various organizations in the sample have varied levels of operational efficiency in these particular indicators.

Findings based on SEM analysis

Financial Health Assessment has a significant positive impact on both Strategic Practices and Operational Efficiency.

Industry Trends also positively influence both mediators but have a stronger influence on Strategic Practices than on Operational Efficiency.

Operational Efficiency has a robust positive relationship with Perceived Financial Health.

Despite the positive influence of Industry Trends and Financial Health Assessment on Strategic Practices, the latter does not have a significant direct effect on Perceived Financial Health.

It can be inferred that while Strategic Practices might be influenced by the financial health assessment and industry trends, it doesn't translate directly into perceived financial health. Instead, operational efficiency, possibly as a product of strategic practices and financial health insights, plays a more pivotal role in shaping perceptions about financial health.

Suggestions

- The study of the data shows that age may have varying levels of effect on different evaluation elements. While age distinctions clearly affect operational efficiency and external influences, other variables including financial health assessment, strategic strategies, and perceived financial health tend to show a more muted sensitivity to age differences. The F-values and associated significance levels capture the statistical significance of these age-related differences, which in turn give important clues about the nature and extent of the divergences across various age groups.
- Descriptive statistics on operational efficiency parameters, which include asset turnover, working capital management, and inventory turnover, also provide useful information. The mean values give us information about how entities in the sample typically perform in relation to these specific measures. In addition, the standard deviations highlight the range of operational efficiency levels displayed by distinct organizations within the sample for these particular measures by illuminating the breadth of variability around these means.

Conclusion

Finally, the thorough survey carried out here demonstrates a fair representation of genders, underscoring the dedication to just inclusion in the study. The age distribution variety, particularly the significant presence in the 35–44 age group, adds levels of depth to the collected data. Furthermore, the high percentage of responders from the technology and healthcare sectors highlights the importance of these areas for the research. These combined results present a thorough demographic profile that enables a deeper comprehension of the sample's characteristics in regard to gender, age, and industrial sector. REICE | 49

The analysis of the data also clarifies the complex link between age and several evaluation parameters. The complex interactions between age and assessment results are highlighted by the differing degrees of effect that age has on various aspects, as shown by differences in operational efficiency and outside influences. The rigor of this insight is strengthened by the examination of statistical significance through F-values and significance levels, which gives a greater grasp of how age groups affect the assessment variables.

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