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How Digital Capability and Transformation Drive Financial Performance, Flexibility, and Quality in Small Businesses

Anisa Ilham Permata[1], Frank Aligarh[2]

[1]Department of Islamic Accounting, Faculty of Islamic Economics and Business, Universitas Islam Negeri Raden Mas Said Surakarta, Indonesia

[2] Department of Islamic Accounting, Faculty of Islamic Economics and Business, Universitas Islam Negeri Raden Mas Said Surakarta, Indonesia

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ABSTRACT

Digital business transformation presents significant potential for enhancing the performance of small businesses in Indonesia; however, the low digital capabilities among small business actors pose a primary challenge in optimally leveraging these opportunities. The primary objective of this research is to analyze the impact of digital capabilities and digital transformation on the performance of small businesses, measured through financial performance, flexibility, and quality of performance. A total of 116 questionnaires were utilized in this study. Data were analyzed using structural equation modeling. The findings reveal that digital capabilities positively influence financial performance and flexibility but do not impact quality of performance. In contrast, digital transformation positively affects financial performance, flexibility, and quality of performance. Theoretically, this study supports the adaptive structuration theory and dynamic capability theory, which emphasize that knowledge is the most valuable asset in the digital age. Practically, this research contributes to the relevant literature by highlighting the relationships between digital capabilities, flexibility, and quality of performance.

Corresponding Author:

Anisa Ilham Permata,
Department of Islamic Accounting
Faculty of Islamic Economics and Business
Universitas Islam Negeri Raden Mas Said Surakarta,
Email: anisailham19@gmail.com

1. INTRODUCTION

Small businesses are one of the backbones of the economy, especially in Indonesia, playing a vital role in creating jobs and driving economic growth. These small businesses, operated by individuals or small groups, often function locally with a diverse range of products and services. The main advantage of small businesses lies in their flexibility and creativity in adapting to market changes, which has significant potential to enhance community welfare (Vinatra, 2023). Small businesses are a key pillar

that drives the economy, especially when they have the willingness and ability to adapt to various changes.

According to information from the Central Statistics Agency, the fluctuating economic growth in Indonesia over the past five years has also occurred in the city of Surakarta. In Central Java, economic growth was recorded at 5.30% in 2018, rising to 5.40% in 2019, but then drastically decreasing to -2.65% in 2020. In 2021, growth rose again to 3.33%, reaching 5.31% in 2022. Meanwhile, in Surakarta, the economy has also fluctuated over the past three years, with growth at 5.75% in 2018, a slight increase to 5.78% in 2019, followed by a decline to -1.76% in 2020, then increasing to 4.01% in 2021, reaching 6.25% in 2022, and standing at 5.57% in 2023.

According to the Central Statistics Agency, in 2023, the economy in Surakarta grew by 5.57%, although this represented a slowdown compared to the previous year's growth of 6.25%. This decline was primarily due to a decrease in exports influenced by global conflicts, which also impacted the national economy. Nevertheless, Surakarta managed to maintain economic growth through various initiatives, such as developing tourist destinations, hosting major events, boosting the trade sector, food and beverage, accommodation, vehicle rental businesses, and construction sector developments. Some major construction projects completed in 2023 include Sheikh Zayed Mosque, Solo Safari, the Palang Joglo overpass, and Balekambang Park.

This year, many business units have successfully adapted to changes in the external environment through various business innovations, including adopting digital technology in their operations (Gunawan Adi Pratio et al., 2023). In recent years, the digital economy in Indonesia has grown rapidly. The use of digital technology continues to expand and now reaches almost all regions. Digital transformation has significantly impacted society and industry by adopting digital technology (Vial, 2019). According to a survey conducted by APJII (2024), in that year, the internet penetration rate in Indonesia reached 79.50%. This means that 79 out of 100 Indonesian citizens used the internet in 2024. Compared to data from 2018, there was an increase of 14.70 percent over the past five years. This indicates that Information and Communication Technology (ICT) has experienced rapid development over the past five years, especially during the pandemic, and the digital economy industry has a positive growth outlook for the future.

The Regional Research and Development Agency (Balitbangda) of Surakarta City has stated that small businesses in Surakarta face various major challenges in maintaining productivity and business sustainability, including institutional issues, supply chain management, operational concerns, capital, financial management, and the skills of entrepreneurs and workers in implementing digital technology, as well as sales. Small businesses in Surakarta encounter several weaknesses in adopting digital technology. Internal limitations, such as small business scale, minimal workforce, and lack of business capital stability, often lead to limited knowledge and skills among human resources. Cooperation and collaboration with external parties can have a positive impact on business development. Utilizing these networks can help enhance the dynamic capabilities of small businesses, particularly in terms of developing knowledge and skills among human resources, strategic planning, and marketing capabilities.

Currently, the Indonesian Chamber of Commerce (Kadin) and the Indonesian Government are promoting the improvement of national small business performance through the implementation of digitalization, aiming to enhance competitiveness, become global players, and focus on exports. The government and Kadin are actively encouraging small business actors in Indonesia to enter the digital ecosystem, with a target of connecting 24 million small business units digitally by 2023, increasing to

30 million units by 2024. To achieve this, Kadin supports various digital transformation programs aligned with the efforts of the Ministry of Cooperatives and SMEs to provide integrated business service centers to facilitate the transformation and enhance the competitiveness of small businesses.

To achieve success in digitalization, business actors can adopt a digital mindset. This means that entrepreneurs must develop a digital mindset encompassing the organizational capabilities that support collaboration, innovation, knowledge sharing, continuous improvement, agility, and flexibility, as well as the belief that digital technology is a strategic part of the organization (Solberg et al., 2020). The concept of digital capability involves the use of digital technology to transform business models. This is done by understanding customer needs, creating new media for marketing and sales, and communicating with consumers. Digital capabilities aim to integrate technology into business, promote sustainable development, and alter consumer behavior through digitalization.

The challenges that small businesses will face in the future, which need to be collectively addressed by all stakeholders, include aspects of innovation and technology, digital literacy, productivity, legality or licensing, financing, branding and marketing, human resources, standardization and certification, equitable mentoring, training, facilitation, and the establishment of integrated databases (Gunawan Adi Pratio et al., 2023). Given these challenges, small business actors must enhance their adaptive capabilities through digitalization and understand effective technology usage. However, many of them still face difficulties in transitioning to new technologies due to limited digital capabilities (Bai et al., 2021; Erlanitasari et al., 2020; Pfister & Lehmann, 2023). If business actors solely rely on traditional business models, this leads to decreased competitiveness, especially since new models that support digital transformation currently dominate the market (Slavković et al., 2023).

In response to these challenges, Vial (2019) and Nousopoulou et al. (2022) explain that dynamic capabilities are crucial for addressing the challenges of digital transformation. Digital transformation requires specific skills such as information literacy, security, automation, and cloud computing. Effective digital capabilities, which encompass the creative and secure use of technology, have been shown to enhance innovation and the performance of small businesses (Heredia et al., 2022; Khin & Ho, 2019). The performance of small businesses is related to their ability to produce useful outcomes in the future and support better decision-making. Performance includes outcomes, processes, and foundations. Outcomes encompass conventional perspectives such as revenue and unconventional aspects like social welfare. The processes involve innovation and working conditions. Foundations include competencies and partnerships. Performance is a complex concept determined by its processes and inputs (Prakasa & Jumani, 2024).

Previous research indicates that the measurement of small business performance can be applied across various classifications (Ferreira et al., 2020; Vrontis et al., 2022). According to Kafetzopoulos (2022), aspects such as financial performance, non-financial performance, innovation, and quality can be utilized to assess the overall performance of a company. Furthermore, Prakasa & Jumani (2024) identify six dimensions for measuring the performance of adaptive organizations: competitiveness, finance, service quality, flexibility, resource utilization, and innovation.

Research conducted by Prakasa & Jumani (2024) asserts that technological capability and digital business transformation have a direct and significant impact on small business performance, both financially and in terms of flexibility and quality. Similar research by Rupeika-Apoga et al. (2022) demonstrates that digital capability significantly impacts small business performance. Additionally, Wang et al. (2022) indicate that digital capability has a positive significant effect on corporate

performance. However, a study by Heredia et al. (2022) presents contrasting results, showing that digital capability does not directly affect corporate performance.

In general, digital transformation represents a significant and comprehensive change in the application of technology to enhance business performance. Digital transformation refers to changes that occur or are influenced by the implementation of digital technology across various aspects of human life (Ganawati et al., 2021). The digital changes occurring in society and the economy have increasingly made it clear that business and technology evolve together. This happens as companies continue to respond to new opportunities and challenges arising from the strategic digitization of their activities (Kraft et al., 2022). Moreover, the relationship between digital business transformation and business performance is closely related to how entrepreneurs manage their knowledge and capabilities in the context of digital technology changes. This relationship can be explained through dynamic capability theory, a theoretical approach to understanding a company's ability to navigate rapidly changing environments.

Research by Winarsih & Haviv (2024) found that digital business transformation positively impacts financial performance. Other studies by Prakasa & Jumani (2024) indicate that digital business transformation has a direct and significant impact on small business performance, both financially and in terms of flexibility and quality. Research by Huo et al. (2021) reveals that digital business transformation positively influences flexibility performance. Subsequently, research by Rossini et al. (2021) states that digital business transformation positively affects flexibility performance. Studies by Saryatmo & Sukhotu (2021) and Alathamneh & Al-Hawary (2023) found that digital business transformation positively influences performance quality. Furthermore, research by Anbree et al. (2022) indicates that digital transformation does not significantly affect corporate performance.

Based on the background above and the limitations of previous research, this study aims to analyze the impact of digital capabilities and digital business transformation of small business on efforts to enhance business performance through the measurement of financial performance, flexibility, and quality. This research is beneficial in improving the financial performance, flexibility, and quality of small businesses through the adoption of digital technology. With digital capabilities, small businesses can manage their finances more efficiently, adapt more quickly to market changes, and enhance the quality of their products and services. Additionally, digital transformation strengthens strategic management, develops human resource skills, and opens access to broader markets, thereby increasing competitiveness and business sustainability. The primary theoretical perspectives used in this study are dynamic capability theory (DCT) and Adaptive Structuration Theory, which are relevant for exploring the performance of high-dynamics small business.

Literature Review

Dynamic capability Theory

According to Teece et al. (1997), the ability to create new competitive advantages is termed as "dynamic capabilities." The term "dynamic" emphasizes the capacity to update competencies to align with changes in the business environment, particularly when innovation is required due to rapid technological shifts and unpredictable market conditions. Meanwhile, "capabilities" underscores the critical role of strategic management in adjusting, integrating, and reorganizing the skills and resources of an organization to meet the demands of a changing environment.

Dynamic capabilities are viewed as a combination of extensive organizational capacities and specific actions that collectively trigger change within the organization. At a more general level, Yeow

et al. (2018) assert that dynamic capabilities encompass three primary capacities: sensing, seizing, and transforming. This broad capacity is then realized through a series of specific organizational actions that work in concert to generate change. Therefore, in the context of business, dynamic capabilities refer to a company's ability to navigate rapidly changing environments, address potential issues, and make timely market-oriented decisions by adapting internal resources and capabilities. Essentially, digital capabilities are closely related to the three main characteristics of dynamic capabilities (sensing, seizing, and transforming) (Wang et al., 2022).

Adaptive Structuration Theory

This theory was originally introduced by Gerardine DeSanctis and Marshall Scott Poole in 1994. According to DeSanctis and Poole (1994), Adaptive Structuration Theory (AST) elucidates the interconnections among advanced technology, social structures, and human interactions. The theory posits that the rules and resources provided by technology and institutions shape human activities. Before technology is created, social structures such as hierarchies and work procedures already exist within organizations. As technology is developed, some of these structures are incorporated, modified, or combined, resulting in the formation of new structures within the technology. Technology then provides new rules and resources that can be utilized in social interactions, such as voting procedures or stored data. The structures within technology and human actions continuously influence each other, creating change. To understand how technology can transform organizations, it is essential to differentiate between the social structures embedded within technology and those present in actions, and to examine how the two interact.

Luckandi (2019) further clarifies this theory, which employs four primary structures. First, the structuration of new technology, encompassing the features of the technology and the organizational attitudes toward it, including decision-making and management. Second, task-related structuration and organizational environment, which involves assessing task characteristics and organizational structures. Third, the most critical structuration refers to how organizations interact with new technology, including the outcomes of technology implementation. Fourth, new social structures emerge from the new rules and resources resulting from social interactions. Another influencing factor is the internal systems of the organization, which affect how members interact and respond to changes.

The aforementioned factors can be simplified into social interactions that influence the adaptation of new technology within organizations. There are four aspects of appropriateness: first, Appropriation Moves, which refers to the organization’s choice to utilize technological structures. Second, Faithfulness of Appropriation, which indicates the level of trust in the technology. Third, Instrumental Uses, which represent the organization's genuine need to employ the technology. Fourth, Persistent Attitudes toward Appropriation, which capture the organization's daily attitudes toward technology usage. These aspects influence how technology is adapted within the organization and support decision-making, participation, and conflict management. The ultimate outcome is a tangible evaluation of efficiency, quality, and commitment in organizational decisions, highlighting the significance of technology adaptation for organizational advancement.

Digital Capability

According to Ong et al. (2021), digital capability encompasses skills that extend beyond information technology, incorporating specific technologies such as social media and mobile devices, as well as analytical abilities to optimize big data. This capability can also be viewed as either an outcome or a process within digital operations. Technological competence and digital skills are crucial in the innovation process, particularly in new product development. Effective and efficient

management of technology is essential, even when technology is optimally implemented within an organization. Digital capability encompasses the skills and expertise necessary to leverage digital technologies for the creation of new products. To succeed in digital transformation, companies must build capabilities across various domains, which vary according to their specific sectors and needs. A flexible IT infrastructure and robust information management are also vital in supporting this transformation (Khin & Ho, 2020).

The dynamic capabilities approach within organizations emphasizes that these capabilities are a key factor in maintaining sustainable competitive advantage amidst continuously changing competition. Dynamic capabilities are defined as the specific abilities that enable organizations to develop new products and processes and to adapt to market changes (Teece et al., 1997). The digital capabilities of small business refer to the organization's readiness to engage in digitalization and transform into digital enterprises. This capability is crucial as a foundational step and a driving force towards digital maturity. Therefore, it is essential to understand the key dimensions of digital capability, as these can be measured and utilized to support digital business models (González-varona et al., 2021). Digital capability plays a significant role in the successful performance of small business, serving as a primary resource for achieving enhanced performance and providing a competitive advantage (Prakasa & Jumani, 2024).

Digital Business Transformation

Business transformation has long been a term employed by strategy writers, yet summarizing its literature proves challenging due to the vast diversity of definitions. At a conference hosted by the Corporate Renewing Centre at INSEAD, efforts to reach a consensus on a common definition culminated in a two-dimensional concept: "A fundamental change in the logic of an organization that triggers or results from significant changes in behavior" (Muzyka et al., 1995).

From the perspective of the digital age, digital transformation highlights the substantial changes induced by the pervasive nature of digital technology. With the advent of digital technology, innovation and business development are undoubtedly accelerated. In this dynamic and competitive new global economy, success hinges on the integration of knowledge, technology, and innovation within products and services. Furthermore, the concept of a circular economy replaces outdated models with more sustainable and efficient systems. Digital technology is also reshaping industry operations, dismantling traditional boundaries between sectors (Ismail et al., 2017).

In this context, small businesses exhibit distinctive characteristics such as flexibility, resource limitations, and specialization capabilities that differentiate them from larger firms. These characteristics significantly influence the digital transformation process. Digitalization presents opportunities for enhancing social and environmental well-being; however, it can also introduce challenges related to sustainability (Pereira et al., 2020). Beyond economic implications, the digital transformation of small businesses also impacts social and environmental aspects, including the loss of routine jobs and the increased material consumption that adversely affects the environment (Costa et al., 2023; González-varona et al., 2021).

Financial Performance

According to Goso & Palatte (2023), financial performance encompasses both the processes and outcomes achieved by an organization in delivering services or products to its customers. Financial performance is deemed satisfactory if it contributes to the enhancement of business operations. The

growth and development of a business require complementary elements, with the improvement of financial performance being one of the critical efforts to achieve this. Nurmalasari et al. (2023) elucidate that the financial performance of small businesses includes the results derived from providing products or services, which can be categorized into three aspects: organization, type of business, and asset size. This performance is essential for assessing the financial health of a business and aiding small enterprises in navigating competition. Financial resources are pivotal to the success of small businesses, which are inherently reliant on their financial performance. Performance is evaluated based on assets, turnover, sales, and profit over a specified period, with assets assessed according to their liquidity—specifically, how quickly they can be converted into cash (Jubaedah & Destiana, 2016).

The performance of small businesses in Indonesia has experienced rapid growth in recent years. One influencing factor is the adoption of digital business practices. Digital business represents a strategy that leverages digital technologies to communicate with consumers and stakeholders (Chaerunisak et al., 2024). According to Armiani et al. (2021), the use of digital business technologies can enhance financial performance, including sales and profit, as well as non-financial performance such as service quality, product excellence, achievement of production targets, and information effectiveness.

Flexibility Performance

According to Gupta & Goyal (1989), flexibility is the capacity of a system to adapt to changing conditions or instabilities influenced by environmental factors. The implementation of flexibility aims to enhance competitiveness and financial performance by swiftly adapting to change. Workforce flexibility is related to labor deregulation and reflects the ability to operate under changing conditions, whether predictable or unpredictable (Wahyuni, 2014).

With the rapid advancement of financial technology, particularly in terms of transaction volume, data management, and security, organizations are presented with new opportunities. For instance, cloud-based data technology offers high flexibility, cost efficiency, and scalability that can be tailored to meet the continuously evolving demands. This enables business operators to enhance and adjust their operations more effectively and efficiently (Hasan, 2020).

According to Saputra et al. (2020), in the face of digital business transformation, small businesses must possess business flexibility encompassing three levels: operational, tactical, and strategic. Strategic flexibility, which focuses on long-term outcomes, allows businesses to manage various strategies in response to change and uncertainty. This involves responding to dynamic and competitive market demands. This type of business flexibility includes learning, problem-solving, resource reconfiguration, and networking. Beyond merely surviving change, business flexibility also enhances innovation performance and knowledge management, enabling organizations to respond effectively to challenges and gain a competitive edge.

Quality Performance

Performance quality refers to how effectively an organization or small business achieves its objectives and fulfills its responsibilities. The importance of performance quality lies in ensuring that the work carried out aligns with the company's standards, thereby attaining desired business goals and meeting expectations. High performance quality can also enhance employee motivation and morale, assisting the company in achieving a competitive advantage in the marketplace (Dahman et al., 2023). The performance of human resources significantly influences business development, both in the short term and long term. Superior human resources drive the company toward greater progress (Suhariyanto, 2023).

Moreover, digital capabilities in quality performance are a key factor supporting the enhancement of work quality. The ability to implement programs focused on improving employee competencies, strengthening relationships with suppliers and consumers, and enhancing employee welfare has been shown to improve the performance quality of small businesses (Prakasa & Jumani, 2024).

Hypotheses Development

The Influence of Digital Capability on Financial Performance

In the context of dynamic capability theory, digital capability can be regarded as a dynamic capability, defined as an organization's ability to create new products and processes and respond to changing market conditions (Aisyah et al., 2022). Digital capability plays a critical role in enhancing a company's financial performance through various mechanisms, including operational efficiency, improved decision-making, product innovation, and enhanced customer experience (Wang et al., 2022). Companies that can effectively leverage digital technologies typically possess a competitive advantage that can be interpreted as improved financial performance.

Research conducted by Wang et al. (2022) demonstrates that digital capability significantly influences financial performance. Similarly, the study by Prakasa & Jumani (2024) reveals a positive effect of digital capability on financial performance. Additionally, the research by Nasiri et al. (2020) also indicates that digital capability impacts financial performance. Therefore, the hypothesis in this study is:

H1: Digital capability positively influences financial performance.

The Influence of Digital Capability on Flexibility Performance

According to dynamic capability theory, which describes an organization's ability to consistently create, expand, or transform its resource base—including routines, processes, tangible assets, intangible assets, and human capabilities—this capability enables companies to continuously adjust and update their operational capabilities (Neri et al., 2023). With this capability, companies can leverage digital capabilities to enhance their flexibility and responsiveness to change. This allows firms to remain competitive in dynamic and rapidly changing business environments. Flexibility is recognized as a crucial ability for organizations in managing tasks. This capability becomes a primary tool for achieving competitive advantage, especially in highly competitive markets and conditions of significant uncertainty (Ramos et al., 2023).

Research by Prakasa & Jumani (2024) found that digital capability positively influences flexibility performance. Furthermore, a study by Lee et al. (2022) asserts that digital capability affects flexibility performance. Hence, the hypothesis in this study is:

H2: Digital capability positively influences flexibility performance.

The Influence of Digital Capability on Quality Performance

Dynamic capability theory elucidates how digital capability can impact the quality of organizational performance. With robust digital capabilities, organizations can adapt better to change, enhance the efficiency and quality of processes, and support sustainable innovation. All these factors contribute to an overall increase in quality performance, which is essential for achieving and maintaining a competitive advantage in dynamic markets. Dynamic capabilities are described as

"unique and valuable generic resources" that modern organizations can utilize as a foundation for acquiring and sustaining long-term competitive advantage (Bieńkowska & Tworek, 2021).

Research by Ferreira et al. (2020) found that digital capability positively influences quality performance. The subsequent study by Prakasa & Jumani (2024) indicates that digital capability affects the quality of corporate performance. Further research by Wang et al. (2022) asserts that dynamic capabilities influence the quality of corporate performance. Therefore, the hypothesis in this study is:
H3: Digital capability positively influences quality performance.

The Influence of Digital Business Transformation on Financial Performance

Adaptive Structuration Theory elucidates the interplay between technology and social structures within an organization (DeSanctis & Poole, 1994). In the context of digital transformation, AST aids in comprehending how digital technologies—such as information systems, digital platforms, and automation tools—are not merely introduced into organizations but are also adapted and leveraged by individuals and groups.

Globally, digital transformation signifies a fundamental and comprehensive shift in the utilization of technology to enhance corporate performance (Winarsih & Haviv, 2024). Digital business transformation encompasses profound and extensive technological changes. For instance, companies no longer solely rely on physical stores to capture market share; they are also expanding their reach into digital markets (Prakasa & Jumani, 2024). This transformation within digital business presents new economic opportunities and fosters a more effective and efficient economy. By enhancing operational efficiency, it can help small businesses achieve better performance. Moreover, the availability of digital business transformation simplifies financial management, making it swift, straightforward, and secure (Umami et al., 2023).

Research conducted by Winarsih & Haviv (2024) indicates that digital business transformation positively influences financial performance. Another study by Prakasa & Jumani (2024) corroborates that digital business transformation has a favorable impact on corporate financial performance. Hence, the hypothesis for this research is:
H4: Digital business transformation positively influences financial performance.

The Influence of Digital Business Transformation on Flexibility Performance

In Adaptive Structuration Theory, the capacity of individuals and groups to utilize technology creatively and flexibly is emphasized, allowing them to tailor technology to their needs and create new structures. Digital transformation directly impacts organizational flexibility by compelling companies to continuously innovate and adapt to evolving technological advancements and changing market demands (Wang et al., 2022).

This transformation fosters a more interconnected, intelligent, and responsive system to market changes, enabling companies to develop more innovative products. The shifts also make lifestyles, work practices, and interactions more flexible, particularly in the workplace. Labor flexibility in this era encompasses the freedom to work from diverse locations and to set work hours according to personal preferences, which enhances efficiency and productivity. To remain competitive in the age of digital business transformation, it is crucial for the workforce to adapt and utilize digital technology as a primary tool for communication and task completion. Furthermore, technological advancements support the rise of freelance workers who enjoy flexible contracts and high degrees of work autonomy (Ilmiah et al., 2021).

Research by Huo et al. (2021) found that digital business transformation positively affects flexibility performance. Additional studies by Prakasa & Jumani (2024) and Rossini et al. (2021) also

affirm that digital business transformation positively impacts flexibility performance. Consequently, the hypothesis for this research is:

H5: Digital business transformation positively influences flexibility performance.

The Influence of Digital Business Transformation on Performance Quality

Adaptive Structuration Theory underscores that technology is not merely a tool but an integral component of the social structure that interacts with existing rules and resources within an organization (DeSanctis & Poole, 1994). The application of this technology can enhance operational efficiency, optimize decision-making, and foster new innovations, all of which have a positive effect on performance quality in the digital era. Digital transformation, as a form of environmental change in business, necessitates that companies possess robust dynamic capabilities. These capabilities enable firms to enhance their performance quality through various mechanisms, such as improved operational efficiency, better decision-making, product innovation, and enhanced customer experiences (Alathamneh & Al-Hawary, 2023).

Digital business transformation plays a pivotal role in enhancing the quality of corporate performance through various mechanisms, including increased operational efficiency, improved decision-making, product innovation, and superior customer experiences. In today's digital era, digital transformation is not merely an option; it has become essential for remaining competitive and relevant in the ever-evolving global market. The technology associated with digital transformation equips companies to achieve quality performance and prepare the necessary infrastructure for implementing such technologies. Companies are utilizing modern technology that is continually updated (Alathamneh & Al-Hawary, 2023).

Research conducted by Saryatmo & Sukhotu (2021) found that digital business transformation positively influences performance quality. Additional studies by Prakasa & Jumani (2024) and Alathamneh & Al-Hawary (2023) also confirm that digital business transformation positively impacts performance quality. Therefore, the hypothesis for this research is:

H6: Digital business transformation positively influences performance quality.

2. METHOD

This study employs a quantitative approach conducted in the Solo Raya region. A survey method was adopted, utilizing both online and offline questionnaires. The population for this research consists of small business operators who use digital technologies such as Shopee, Gojek, Grab, and others in Solo Raya. A purposive sampling method was employed, considering several criteria: (1) the business must fall within the micro, small, or medium category, and (2) it must utilize digital technology. A total of 116 responses were collected and used as data for this research. Each item in the survey was evaluated using a five-point Likert scale, ranging from 'strongly disagree,' 'disagree,' 'neutral,' 'agree,' to 'strongly agree.' Additionally, this study implements partial least squares (PLS) analysis using SmartPLS software to assess both the measurement and structural models.

3. RESULTS AND DISCUSSION

Results

Descriptive Analysis

Table 1 presents the demographic data of the respondents in this study. The table indicates that the number of male respondents (34.48%) is lower than that of female respondents (65.52%). Furthermore, regarding educational background, the majority of respondents have completed high

school or an equivalent level (47.41%), while the lowest percentage falls under other educational categories (0.86%). The respondents reported varying monthly incomes, with the majority earning less than 10 million (82.91%), followed by those earning between 20-30 million (13.68%), 30-60 million (2.56%), and more than 60 million (0.85%). A total of 108 respondents (93.10%) are still utilizing digital technology, while eight respondents (6.90%) have currently ceased using digital technology.

Table 1. Respondent Data

Characteristics	Category	Total	Procentage
Gender	Male	40	34.48 %
	Female	76	65.52 %
Education	SD	2	1.72%
	SMP	5	4.31%
	SMA/Sederajat	55	47.41%
	Diploma/S1	53	45.69%
	S2	0	0.00%
	Lainnya	1	0.86%
Type of Business	Culinary	76	65,52%
	Fashion	11	9,48%
	Grocery store	4	3,45%
	Craft	10	8,62%
	Beauty	5	4,31%
	Service	10	8,62%
Income per month	< 10 juta	97	82.91%
	20-30 juta	16	13.68%
	30-60 juta	3	2.56%
	> 60 juta	1	0.85%
Using e-commerce	Yes, Currently using	108	93.10%
	Yes, But now not using	8	6.90%

Source: Data analysis

Measurement Model Test

The results of the convergent and discriminant validity tests indicate that all items are valid and meet the required standards. Convergent validity is assessed through the loading factor values and the average variance extracted (AVE). Table 2 demonstrates that the indicators are valid, as all loading factor values exceed 0.7 and the AVE values exceed 0.5. Reliability testing can be evaluated using Cronbach's alpha and composite reliability. Cronbach's alpha is employed to assess other constructs, while composite reliability is used to determine overall reliability. The values for both Cronbach's alpha and composite reliability should be greater than 0.7. The testing results have shown that all variables satisfy the criterion of exceeding 0.7 for both composite reliability and Cronbach's alpha. Therefore, it can be concluded that the measurements used in this study have met the reliability testing standards.

Table 2. Convergent Validity and Reliability

Variable	Indicator	Cross Loading	Cronbach's Alpha	rho_A	Composite Reliability	AVE

Digital Business Transformation	1.	Market share	0.759	0.853	0.853	0.891	0.576
	2.	Business process speed	0.749				
	3.	Customer satisfaction index	0.723				
	4.	Number of innovations or new products	0.776				
	5.	Decision-making speed	0.787				
	6.	Reduction in operational costs	0.758				
Digital Capability	1.	Comparison of technological capability with competitors.	0.762	0.803	0.805	0.863	0.558
	2.	Competitive position of the business.	0.723				
	3.	Relevance of the technology to customer needs.	0.781				
	4.	Level of technology adoption by customers.	0.745				
	5.	Ease of use of the technology.	0.723				
Financial Performance	1.	Sales increased	0.836	0.928	0.929	0.944	0.738
	2.	Profit increased	0.875				
	3.	Gross profit increased	0.823				
	4.	Net profit increased	0.923				
	5.	Return on equity increased	0.896				
	6.	Return on investment increased	0.795				
Flexibility Performance	1.	Production capacity	0.738	0.781	0.797	0.858	0.604

	2. Product flexibility	0.701				
	3. New product development	0.821				
	4. Distribution time	0.839				
Quality Performance	1. Increased productivity	0.819	0.862	0.893	0.903	0.701
	2. Product quality level	0.909				
	3. Satisfaction index	0.757				
	4. Employee welfare	0.857				

Source: Data analysis

Discriminant validity can be assessed by examining the Fornell-Larcker criterion values. This measurement indicates that the correlation of a variable with itself should not be less than its correlation with other variables. Table 3 presents the results of the discriminant validity test, determined by adhering to the Fornell-Larcker criteria. Given that the requirements for loading factors, average variance extracted (AVE), and the Fornell-Larcker criterion have been met, it can be concluded that all latent variables have passed the validity test.

Table 3. Fornell-Lacker Criterion to Discriminant Validity

Variabel	DBT	DC	FP	FLP	QP
DBT	**0.759**				
DC	0.659	**0.747**			
FP	0.610	0.606	**0.859**		
FLP	0.674	0.563	0.583	**0.777**	
QP	0.535	0.343	0.503	0.631	**0.837**

Source: Data analysis

Notes: DBT = Digital Business Transformation; DC = Digital Capability; FP = Financial Performance; FLP = Flexibility Performance; QP = Quality Performance

Discriminant validity was also tested using the heterotrait-monotrait (HTMT) ratio of correlations. Table 4 shows that each variable has an HTMT value below 0.9, indicating that all variables in this study meet the HTMT criteria. Therefore, it can be concluded that discriminant validity has been achieved.

Table 4. Heterotrait-Monotrait Ratio (HtMt) Criterion to Discriminant Validity

Variable	DBT	DC	FP	FLP	QP
DBT					
DC	0.787				
FP	0.681	0.703			

FLP	0.814	0.692	0.686	
QP	0.584	0.384	0.551	0.746

Source: Data analysis

Structural Model Test

Hypothesis testing is conducted by examining the path coefficient and t-statistic values. Using SmartPLS 3.0 software, these values are obtained through bootstrapping analysis. The rule of thumb applied is that the t-statistic should be greater than 1.96 and the p-values should be less than 0.05. The results of the hypothesis testing can be found in the table below:

Table 5. Structural Model Test

Hyphothesis	Original Sample	T Statistics	P Values	Information
H1: DC -> FP	0.360	4.072	0.000	Supported
H2: DC -> FLP	0.210	2.010	0.045	Supported
H3: DC -> QP	-0.017	0.150	0.881	Not Supported
H4: DBT -> FP	0.373	4.186	0.000	Supported
H5: DBT -> FLP	0.536	4.924	0.000	Supported
H6 :DBT -> QP	0.546	5.907	0.000	Supported

Source: Data analysis

From the table, the bootstrapping resampling test shows that the variable digital capability has an original sample value of 0.360 regarding financial performance, with t-statistics of 4.072 and p-values of 0.000. These results indicate that the digital capability variable positively influences financial performance by 0.360 and is significant because t-statistics of 4.072 > 1.96 and p-values of 0.000 < 0.05. Therefore, it can be concluded that H1 is supported because digital capability has a positive and significant effect on financial performance.

The variable digital capability regarding flexibility also has an original sample value of 0.210, with t-statistics of 2.010 and p-values of 0.045. These results show that the digital capability variable positively influences flexibility performance by 0.210 and is significant because t-statistics of 2.010 > 1.96 and p-values of 0.045 < 0.05. Therefore, it can be concluded that H2 is supported because digital capability has a positive and significant effect on flexibility performance.

The variable digital capability regarding quality performance has an original sample value of -0.017, with t-statistics of 0.150 and p-values of 0.881. These results indicate that the digital capability variable does not significantly affect quality performance because t-statistics of -0.017 < 1.96 and p-values of 0.881 > 0.05. Therefore, it can be concluded that H3 is not supported because digital capability does not influence quality performance.

The variable digital business transformation regarding financial performance has an original sample value of 0.373, with t-statistics of 4.186 and p-values of 0.000. These results show that the digital business transformation variable positively influences financial performance by 0.373 and is significant because t-statistics of 4.186 > 1.96 and p-values of 0.000 < 0.05. Therefore, it can be

concluded that H4 is supported because digital business transformation has a positive and significant effect on financial performance.

The variable digital business transformation regarding flexibility performance has an original sample value of 0.536, with t-statistics of 4.924 and p-values of 0.000. These results indicate that the digital business transformation variable positively influences flexibility performance by 0.536 and is significant because t-statistics of 4.924 > 1.96 and p-values of 0.000 < 0.05. Therefore, it can be concluded that H5 is supported because digital business transformation has a positive and significant effect on flexibility performance.

The variable digital business transformation regarding quality performance has an original sample value of 0.546, with t-statistics of 5.907 and p-values of 0.000. These results show that the digital business transformation variable positively influences quality performance by 0.546 and is significant because t-statistics of 5.907 > 1.96 and p-values of 0.000 < 0.05. Therefore, it can be concluded that H6 is supported because digital business transformation has a positive and significant effect on quality performance.

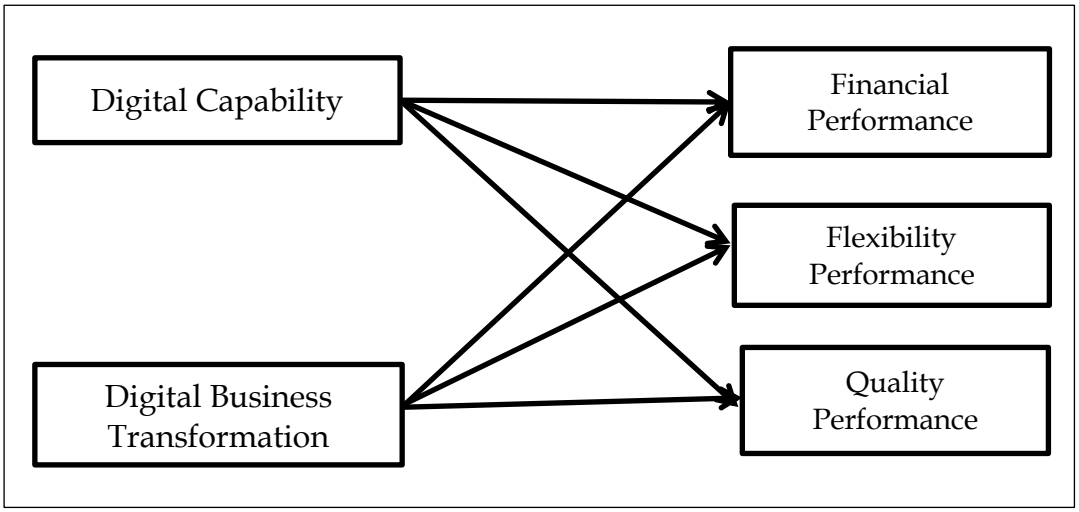

Figure 1: Schematic Diagram of the Study

Discussion

First, this study finds that digital capability has a significant impact on financial performance. The positive coefficient indicates that higher digital capability leads to better financial performance outcomes. Empirically, these findings support the results of Nasiri et al. (2020), Prakasa & Jumani (2024), and Wang et al. (2022). The ability to leverage various digital tools, software, and applications can enhance financial performance, such as through improved budget planning and financial management. This is relevant to the dynamic capability theory, which emphasizes that the ability to quickly adapt to technological and environmental changes is key to enhancing the competitiveness of small businesses. With strong digital capabilities, small businesses can be more responsive to changes, thereby improving their financial performance.

Second, this research reveals that digital capability positively affects flexibility performance. This indicates that digital capability can significantly enhance flexibility performance in small businesses, such as the ability to quickly respond to and meet customer needs. These findings suggest that flexibility performance is an appropriate measure for assessing the adaptive performance of

organizations. Furthermore, this supports the dynamic capability theory, which asserts that digital capabilities enable companies to continuously adjust (flexibly) and update their operational capabilities to remain relevant and competitive (Neri et al., 2023). Additionally, these findings are consistent with previous research by Lee et al. (2022) and Prakasa & Jumani (2024).

Third, digital capability does not impact the quality performance of small businesses. This finding contrasts with the research conducted by Ferreira et al. (2020), Prakasa & Jumani (2024), and Wang et al. (2022), which found that dynamic capabilities influence quality performance. Thus, the third hypothesis is rejected. Several factors contribute to the lack of a significant impact of digital capability on the quality performance of small businesses, including misalignment in business processes, lack of knowledge in using the internet, limitations in the number of computers and internet access, deficiencies in trust and security in internet usage, and high costs for developing and maintaining computers (Haryanti, 2021).

Furthermore, digital business transformation significantly influences financial performance, implying that improved digital management in small businesses enhances their potential to boost financial performance. In line with the Adaptive Structuration Theory, this transformation involves not only the adoption of technology but also changes in organizational structures and processes that support digital management. When small businesses implement effective digital management practices, they can leverage technology to improve operational efficiency and respond to market needs, thereby enhancing their financial performance. In other words, the better the digital management structure within small businesses, the greater their potential for achieving superior financial performance. These findings support previous research by Prakasa & Jumani (2024) and Winarsih & Haviv (2024), allowing hypothesis H4 to be accepted.

Digital business transformation significantly impacts flexibility performance, supporting hypothesis H5. This means that the ability to respond quickly to customer needs is influenced by how well small business can transform their businesses. According to the Adaptive Structuration Theory, the structures and processes formed during this transformation enable small businesses to adapt more effectively to changes in market demand and customer expectations. As small businesses enhance their digital capabilities, they create new opportunities for organizational flexibility, enabling them to respond to customer needs swiftly and efficiently, thus improving their competitive advantage. The results of this study also align with previous research conducted by Huo et al. (2021), Prakasa & Jumani (2024), and Rossini et al. (2021).

The results of hypothesis H6 indicate that digital business transformation affects the quality performance of small businesses. This finding aligns with the Adaptive Structuration Theory, which explains how social structures and technology influence each other within organizational contexts. In this regard, digital business transformation can be seen as a structural change that introduces new practices, tools, and processes that can enhance the quality performance of small businesses. By utilizing this technology, companies can improve operational efficiency, increase accuracy, accelerate responses, enhance product or service quality, make better decisions, innovate products, and provide a better customer experience (Deviastri & Annisa, 2022). These results confirm that hypothesis H6 can be accepted and align with previous research by Alathamneh & Al-Hawary (2023) and Saryatmo & Sukhotu (2021), which stated that the quality performance of small businesses can improve through digital transformation.

4. CONCLUSION

This study finds that digital capability significantly influences the financial performance and flexibility of small businesses, supporting the dynamic capability theory, which suggests that the ability to adapt to technology is key to enhancing competitiveness. However, digital capability does not impact the quality of small business performance. This may be attributed to the limited adaptability of entrepreneurs in business processes during the current era of digitalization and a lack of knowledge and limitations in using the internet. Furthermore, digital business transformation has been shown to positively affect financial performance, flexibility, and quality, in accordance with the Adaptive Structuration Theory, which underscores the importance of structural and process changes within organizations to effectively leverage technology.

This research contributes both theoretically and practically. Theoretically, it offers a new research model to elucidate the relationships between digital capability and digital business transformation concerning small business performance, measured through financial performance, flexibility performance, and quality performance. Practically, this study provides valuable insights for entrepreneurs to seize digital opportunities, promote digital business transformation, and enhance business performance. Like other studies, this research has several limitations. Firstly, the sample size is relatively small, comprising only 116 respondents from the city of Surakarta. Secondly, out of the six expected hypotheses, only five were confirmed.

Based on the findings of this research, the author recommends that future studies increase the sample size in accordance with the desired respondent criteria, and that subsequent researchers include additional indicators or backup questions for each variable.

For small business owners, first, they should consistently enhance their digital capabilities. By doing so, they can thrive and capitalize on the opportunities presented by the digital landscape, drive digital business transformation, and improve their business performance. Second, the government should optimize economic stimulus policies, primarily focusing on supporting small business owners in developing their digital capabilities through training, coaching, mentoring, and various other programs. This strategy will accelerate the recovery of the small business sector in the digital era. In conclusion, this study emphasizes the critical importance of digital capability and transformation in the development of small businesses, particularly in developing countries.

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