

# The Role of Innovation in Improving Small Medium Enterprise (SME) Performance

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The purpose of this study was to examine the role of the innovation variable in improving small-medium enterprise (SME) performance. Also, it will study the impact of dynamic capabilities, knowledge management, and entrepreneurial orientation on SME performance. Then, it will analyse whether innovation can be the mediator variable among the relationship between dynamic capabilities and SME performance, knowledge management with SME performance, and entrepreneurial orientation with SME performance. The research data is obtained from SME data provided by the government of Indonesia and by distributing questionnaires to 350 SMEs in Indonesia. The analytical method used is correlation and regression to determine the relationship among variables and path analysis to determine the direct effect of dynamic capabilities with SME performance, knowledge management with SME performance, entrepreneurial orientation with SME performance and the indirect effect of innovation on SME performance. The results showed that (1) there was a positive influence of dynamic capabilities with innovation, (2) there was a positive influence of knowledge management with innovation, (3) there was a positive effect on entrepreneurial orientation with innovation, (4) there was a positive influence of dynamic capabilities on SME performance, (5) there was a positive influence of knowledge management on the performance of SMEs, (6) there was a positive effect on entrepreneurial orientation with the performance of SMEs, (7) there was a positive influence on innovation with the performance of SMEs, (8) there was a positive influence of dynamic capabilities on SME performance through dynamic capabilities as mediation, (9) there was a positive influence of knowledge management with SME performance through innovation as mediation, and (10) there was a positive influence on entrepreneurial orientation with SME performance through innovation as mediation. The implication of the findings that the innovation variable which has indicators as product

innovation, marketing innovation, process innovation, and organisation innovation plays a crucial role in enhancing the capability of the SMEs.

**Key words:** *Dynamic capabilities, knowledge management, entrepreneurial orientation, innovation and SME performance.*

## Introduction

In the business world, including small and medium businesses (SMEs) today there is rapid competition in line with the growth of the national economy. This condition is due to the markets faced by developing companies, and companies must be able to make a difference by innovating. Companies must be able to create products or services according to the needs of consumers who are increasingly smart in choosing products and services.

SMEs in Indonesia play a very important role as economic support. SMEs are the main driver of the economy with the main function of SMEs being able to provide employment for millions of people absorbed in the formal and informal sectors. SMEs have contributed to the formation of the Gross Domestic Product (GDP) and the SME sector as a source of foreign exchange through the export of various types of products from SMEs.

The company has done a lot of research performance Lin et al., (2008); (Suliyanto & Rahab, 2012); (Ozmen & Deniz Eris, 2012); (Khaliq & Saeed, 2015) stated that market orientation had a positive and significant effect on company performance. Different opinions from research results (Foltean & Feder, 2014); Gholami and Birjandi (2016); (Subagja, Astuti, & Darsono, 2017) that market orientation had no influence on company performance. Company performance can be measured through sales growth, profitability and market share (Lin et al., 2008; Suliyanto & Rahab, 2012). In contrast to Gholami & Birjandi (2016), measurement of company performance is measured through product performance and customer performance.

According to Zahra & Copin (1995) this aspect of performance is very important to strengthen financial performance and survival, especially for small companies operating in high-tech environments that are very competitive, explained (Lee & Tsai, 2005) (Alegre, Fernández-mesa, & Strange, 2005). In accordance with the results of the survey and pre-research questionnaire that has been carried out, from SMEs in Indonesia, it is suspected that there are still some obstacles that are found, among others: (1) very limited capital; (2) lack of qualified human resources; (3) lack of channel for distributing goods; (4) clear legal entity ownership and licensing; (5) difficulties in calculating sales turnover due to manual bookkeeping; (6) development of digital technology / strategy through online marketing; (7) still not yet the maximum ability of SMEs in responding to profit opportunities that are competitive; (8) SMEs are still not maximal in conducting research and monitoring markets,

customers and competitors in running this business because there are still assumptions that bright ideas are less supported by the leadership and only add new jobs and feel burdened to be implemented by the company; (9) lack of product quality assessment and service quality; (10) SMEs have not maximally utilised networks to build good relationships with customers, partners and government institutions; (11) lack of ability of SMEs to innovate both process innovation, product innovation, marketing innovation and management innovation; (12) lack of commitment in implementation of the company's vision and mission; (13) is not yet maximised by SMEs in making changes in adjusting to the challenges of dynamic environmental developments; and (14) not yet maximising SMEs in managing assets so that it affects the company's performance.

Based on Kompas.com edition 14/6/2019 written by Fika Nurul Ulya in Jakarta stated that a survey released by SMEs magazine showed that the involvement of small and medium enterprises (SMEs) in Indonesia could help the country's economic growth. The survey shows that SME income growth has increased rapidly in 2018 and based on a survey that was followed by the top 2000 SMEs in Indonesia showed revenue growth reached 9.3 percent or an average of Rp. 55.1 in 2018 and profits reaching 23.5 percent with an average of around Rp 7.1 billion. This shows Indonesia's GDP growth of 5.17 percent in 2018. According to William Ng as editor in chief of the magazine SMEs stated that Indonesian SMEs are developing positively amid the global economic turmoil. Barriers to rapid technological development and greater regional economic integration are major problems for SMEs. The importance of digital strategies and utilising various resources enhances their ability to deal with a dynamic environment (<https://money.kompas.com/read/2019/06/14>).

Based on these data, a study was conducted on the effect of dynamic capabilities, knowledge management and entrepreneurship on SME performance through innovation. The role of dynamic capabilities, knowledge management and entrepreneurial orientation that can improve innovation and performance of Small and Medium Enterprises (SMEs) is needed to improve the quality of human resources and service quality. SMEs contribute quite a lot in improving the regional economy and are able to create jobs.

### **Dynamic Capabilities**

"Dynamic capabilities are the entrepreneurial ability to adapt to rapidly changing environments". Entrepreneurial orientation is to have an innovative character, be proactive and a risk challenger. Dynamic capabilities can be categorised into entrepreneurial abilities that are able to adapt to dynamic market changes (Teece, Pisano, & Shuen, 1997).

According to Griffith & Harvey (2000) dynamic capabilities that are to unite, develop, configure the competencies of companies, are able to deal with changes in nature quickly.



"Dynamic capabilities are the capabilities of enterprise so as to add rapidly and reconfigure internal and external competencies as to address rapidly changing environments" (Gaye & Dogan, 2013).

Dynamic capabilities are namely how the ability of managers of companies or organisations in integrating, building and configuring the competencies of companies or organisations both from internal sources and from external sources to be able to adapt to rapid environmental changes, so as to make internal and external competencies as the source of sustainable competitive advantage. Dynamic capabilities are a form of knowledge that are able to create value for companies both with the results of innovation and transformation of inputs into outputs in order to obtain sustainable competition. Small and medium businesses (SMEs) in Indonesia really need a comprehensive and integrated approach in an effort to improve business development and maintain customer loyalty so as to improve organisational performance.

Dynamic capabilities can improve innovation and performance of small and medium enterprises (SMEs). In the global market competition, companies are required to continue to develop innovation, by taking into account the structure of the industry by examining from an internal perspective, carefully combining existing resources to obtain core competencies and competitive advantage (Prahalal & Hamel, 1997). Competition in the global market is a company that is able to provide a positive, timely response, fast and responsive services with flexible product innovations and integrated management capabilities with effective coordination, and placing internal competencies and external competencies appropriately so it is the winner (Strønen, Hoholm, Kværner & Støme, 2017).

The company's business model has the ability to create and deliver value to customers with the right mechanism. The business model shows the flow of costs, income and profits and the success of a business depends on the design of the business model and its implementation (Teece, 2018). Dynamic capabilities in this business model are companies having the ability to perceive and capture new opportunities and reconfigure resources, capabilities and opportunities that are detected, and environmental changes that can create and maintain competitiveness (Breznik & Hisrich, 2014).

The design of the model depends on the capability of the company in terms of the capability of accuracy, implementation and transformation of the business model as the output of dynamic capabilities at a higher stage. Dynamic capability has become an organisational routine and managerial expertise and is the company's ability to integrate, build and reconfigure internal competencies that are in accordance with current environmental conditions with a changing business environment. The strength of a company's dynamic

capabilities is key in its ability to sustain long-term profits including redesigning or adjusting business models (Teece, 2018).

Dynamic capability is something broad from dynamic resources, processes and capabilities in which a company must continuously build, adapt and reconfigure internal and external competencies to adapt to the development of the business environment. Dynamic capability functions as the company's capability for its partners. Development and coordination of company resources and corporate partners make changes in the market and business environment. The strength of the company's dynamic capabilities determines the speed and level of ability of the company's resources in adjusting its business model according to the needs and aspirations of customers; this can be achieved by periodically observing opportunities and changing aspects and culture of the company to be more proactive to new threats and opportunities along with business development (Teece, 2018).

Dynamic capability according to Teece (2018) in the business model consists of three components, namely:

- a. Sensing is identifying opportunities by always observing the environment and looking for opportunities that arise within or outside the company's boundaries
- b. Seizing is when there is an opportunity then its potential and value are captured to be learned by choosing the right technology or better understanding the target customers.
- c. Transforming / Reconfiguring is when opportunities are perceived and captured then the company reconfigures resources to match changes and opportunities in the corporate environment.

## **Knowledge Management**

Wigg (2005) in his knowledge management framework model developed by Nonaka is called knowledge conversion. This knowledge conversion model that encourages knowledge creation is socialisation, externalisation, internalisation and combination. This conversion is based on the dichotomy between tacit and explicit knowledge (Dalkir, 2005).

Tacit knowledge refers to knowledge that cannot be easily expressed verbally and articulated, whereas explicit knowledge refers to knowledge that can be easily expressed verbally in a formal, systematic language. Conversion is based on recognising the difference between individual knowledge and collective knowledge, then the framework model work was developed by Nonaka & Takeuchi (2004) into four modes of knowledge conversion (Natek, 2016).

Four knowledge conversion models are identified by tacit to tacit (socialisation), tacit to explicit (externalising), explicit to explicit (combination) and explicit to tacit (internalisation). After undergoing the process of internalisation, then knowledge will enter the metaphor "spiral" of the knowledge register called the SECI model.

Knowledge management indicators in this study are:

- a. Socialisation is the process of creating knowledge by changing tacit knowledge from one entity (individual, group, or organisation) to another entity.
- b. Conversion of tacit knowledge into explicit knowledge is called externalisation.
- c. Combination is the process of creating new explicit knowledge from existing explicit knowledge.
- d. Conversion of explicit knowledge into tacit knowledge is called internalisation.

Organisational knowledge is created by the interaction between the four conversion processes and through the transfer of knowledge from individuals to groups to the organisation / company level.

### **Entrepreneurial Orientation**

Entrepreneurship refers to the nature, character, and characteristics inherent in someone who has a strong will to realise innovative ideas into the real business world and can develop them with resilience. This is the attitude of a true entrepreneur who then develops faster. Entrepreneurship arises when someone dares to develop new businesses and ideas. The entrepreneurship process includes all functions, activities and actions related to the acquisition of opportunities and the creation of business organisations. Therefore, entrepreneurs are people who get opportunities and create organisations to pursue opportunities. (Avlonitis & Salavou, 2007). Entrepreneurial orientation is an effort to create value through business opportunities, appropriate risk-taking management and management communication skills to mobilise human, financial and other raw materials or other available resources to obtain benefits and value from business opportunities. (Kao, 1993: 91); (Killa, 2015) (Estrada, Cruz, Jover, & Gras, 2018); (Baker & Sinkula, 2009); (Li et al. 2008) (Patel & D'Souza, 2009) ; (Nyachanchu, 2017); (Lumpkin & Dess, 2001); (Subagja et al., 2017); (Nadrol et al., 2010) indicators used are as follows:

- a. Autonomy is an action that is not affected by a team or individual to give birth to a vision or idea; autonomy is consistent with the view of entrepreneurial independence needed to bring new ideas to completion, unrestrained by the shackles of corporate bureaucracy.
- b. Proactiveness is the first pioneer company to enter new markets, activeness is a search for opportunities, forward-looking perspectives that are marked by the introduction of new products or services that are first in competition and act in anticipating future demand,

and an attitude of anticipating and acting on changes the future in the market with new methods and product techniques.

- c. Aggressive competitiveness is the tendency of companies to intensely and directly challenge competitors to outperform rivals in the market. Aggressive competitiveness also refers to the level of enthusiasm of the company to be one step further than competitors. Excessive aggression can be risky if the company tries to deal with established competitors.
- d. Taking risk is the tendency to engage in high-risk projects and managerial preferences for decisive action in order to achieve goals. Risk taking involves taking decisive action by exploring the unknown, borrowing large amounts or allocating significant resources to businesses in an uncertain environment. Willingness is to undertake resources for new projects by pursuing opportunities in mind, even though the project already has definite results.

## **Innovation**

Innovation is the tendency of companies to engage and support novelty, new ideas, creative processes and experiments that lead to new products or new technological processes. Innovativeness can also be seen as creative destruction, namely the entry of innovativeness which can disrupt market conditions and stimulate new demand from competitors. Innovation is an idea, idea, practice or object that is realised and accepted as something new by a person or group to be adopted, in other words: innovation is an idea, practice or object which is recognised and accepted as a new thing by any person or group to be adopted (Serna, 2012); (Serna Martinez & Guzman, 2013). So, innovation is an idea, an idea that is realised and accepted by a person or group for improvement in products, processes, marketing and management. The indicators used are as follows:

- a. Product innovation: the introduction of products or services that are actually newly introduced to consumers as a renewal of existing products or have gone through significant improvements related to the characteristics or intended use of the product.
- b. Process innovation: the application of production or delivery methods that are completely new or have gone through significant improvements.
- c. Marketing innovation: the application of new marketing methods or significant improvements in product packaging or design, product placement, product promotion and prices with the aim of increasing sales, meeting consumer needs, opening new markets, and placing company products in the market.
- d. Management / organisation innovation: the application of new organisational methods to business practices, workplace organisation and company external relations.

## **SMES Performance**

Business performance is a result that is made by management continuously (Helfert, 2000). The intended outcome is the result of the decisions of many individuals. Subagja et al., (2017) revealed that organisational performance is something that illustrates the extent to which a group has carried out all the main activities so as to achieve the vision and mission of the institution.

The performance of UKM is basically the same as company performance because UKM is a type of small and medium business. The performance of SMEs in Indonesia is in terms of: (1) added value, (2) business units, labour and productivity, and (3) export value.

The performance of small and medium businesses is a result that is made by the management continuously. The intended outcome is the result of the decisions of many individuals (Helfert, 2000); (Suharto & Subagja, 2018); (Mohammad, Massie, Tumewu 2019); (Ferdinand, 2002).

The indicators used are as follows:

- a. Sales growth: indicated by an increase in product sales.
- b. Profitability: the value of money or unit profit.
- c. Market share: product contribution in controlling the product market compared to competitors who ultimately lead to company profits.

From some of the opinions above, it can be synthesised that the performance of the company / SME is a result made by the management / company continuously and is the result of the decisions of many individuals to achieve the company's goals for both small and medium-sized businesses.

## **Theoretical Framework and Hypothesis**

The theoretical framework in this study is to examine empirical information about the direct and indirect effects of these variables: dynamic capabilities, knowledge management and entrepreneurial orientation, and innovation as mediations on SME performance. Small and medium-sized businesses have so far not developed innovation to create superior value for customers which could improve company performance.

Teece's view of dynamic capabilities is about how the ability of company or organisation managers in integrating, building and configuring corporate or organisational competencies both from internal sources and from external sources to be able to adapt to rapid environmental changes, so as to make internal and external competencies as a source of sustainable



competitive advantage. Dynamic capabilities have unique and different characteristics that give rise to their own history for the company because the company has special characteristics that are able to distinguish the company from similar companies. The uniqueness in a company becomes its own attraction (Teece et al., 1997).

This research is also supported by previous research, in which knowledge management is a forum for managing existing and future knowledge. The creation of continuous knowledge is very much needed at the present time. This is in agreement with the statement (Akhavan, Hosnavi, & Sanjaghi, 2009) that in today's competitive environment, survival, development and profitability of the company very much depends on the acquisition of competitive advantage that is sustainable, including knowledge capability. Applying employee knowledge in organisations has many benefits, including reducing time in work processes, reducing costs, improving customer service, flexibility for rapid changes in the company, creating a learning environment, and increasing productivity and efficiency. This benefit, according to Akhavan, (Akhavan et al., 2009) shows the importance of knowledge in gaining competitive advantage, including in small and medium businesses (SMEs).

In small and medium businesses (SMEs), knowledge management is basically built through the concept of knowledge creation (Knowledge Creation) developed by Nonaka & Takeuchi (2004) (Takeuchi & Nonaka, 2004) in A Dynamic Theory of Organisational Knowledge Creation. Every company has the potential to create knowledge from it. Knowledge management is a process of applying a systematic approach to capturing, structuring, organising and disseminating knowledge throughout the organisation to work faster, use best practices, and reduce the cost of working twice from project to project (Dalkir, 2005).

## **Methodology**

The sampling method used is purposive random sampling, i.e. taking a sample based on criteria determined by the pitch of the researcher. Sample criteria used are 350 respondents who have been operating for at least 5 years of business in SMEs. In this study an analysis tool used is structural equation modelling (SEM) version 24.

## **Result**

### ***Validity and Reliability***

The results of the validity and reliability test of the research variables are as follows in Table 1 and Table 2.

**Table 1:** Results of Test Validity of Research Variables

Variable	Coefficient Correlation	Significance	Cut of Value	Information
X1 Dynamic Capabilities	0.838	0.000	0.05	Valid
X2 Knowledge Management	0.819	0.000	0.05	Valid
X3 Entrepreneurial Orientation	0.932	0.000	0.05	Valid
Y1 Innovation	0.893	0.000	0.05	Valid
Y2 SME Performance	0.827	0.000	0.05	Valid

**Source:** Primary data processed in 2019

**Table 2:** Results of Test Reliability of Research Variables

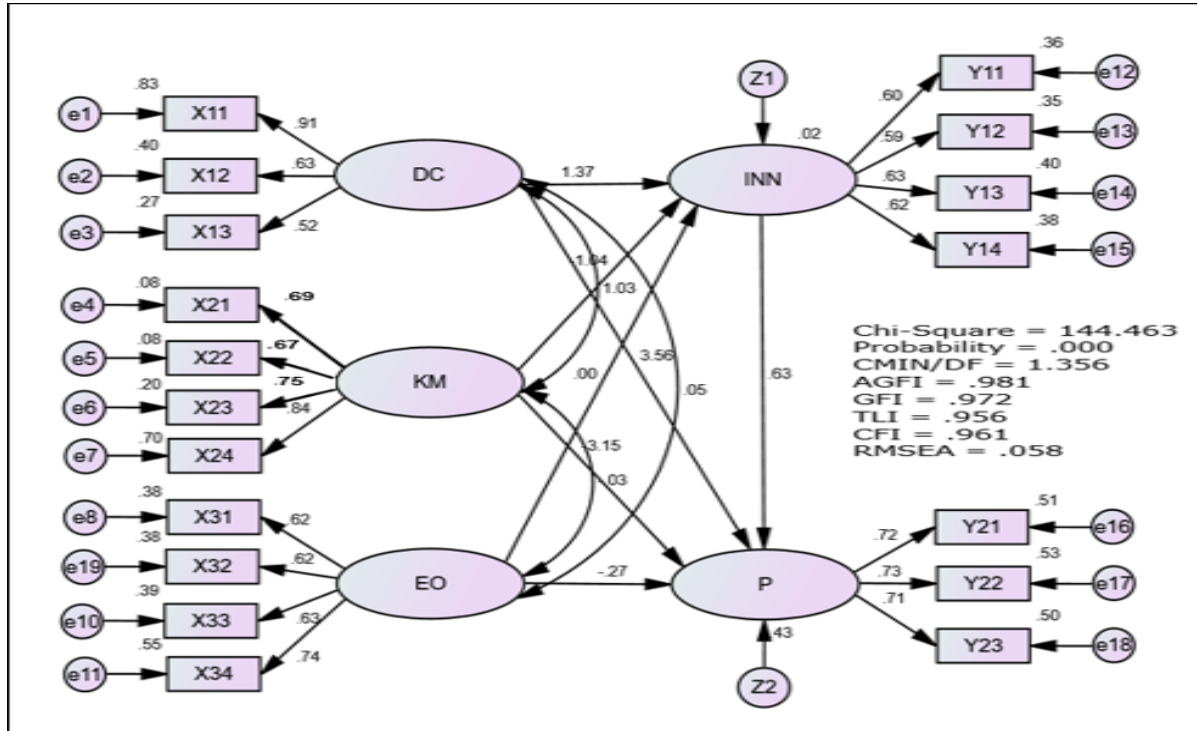
Variable	Total Instrument	Alpha Cronbach	R-Table	Information
Dynamic Capabilities	10	0.774	0,600	Reliable
Knowledge Management	10	0.762	0,600	Reliable
Entrepreneurial Orientation	10	0.767	0,600	Reliable
Innovation	10	0.763	0,600	Reliable
SME Performance	10	0.777	0,600	Reliable

**Source:** Primary data processed in 2019

All instruments are appropriate to use, based on the results of the validity and reliability tests being high.

### Analysis Results SEM

**Figure 1.** SEM Output Results



**Table 3:** Results of Testing the Feasibility of the Research Model

<i>Goodness of Fit Index</i>	<i>Cut off Value</i>	<i>Model Test Results</i>	<i>Information</i>
<i>Chi-Square</i> (df = 109)	< 134,368	144,463	Good
Probability	≥ 0.05	0.000	Good
CMIN/DF	≤ 2.00	1.356	Good
AGFI	≥ 0.90	0.981	Good
GFI	≥ 0.90	0.972	Good
TLI	≥ 0.95	0.956	Good
CFI	≥ 0.95	0.961	Good
RMSEA	≤ 0.08	0.058	Good

**Source:** Primary data processed in 2019

Based on the results of the analysis note that the analysed model is a recursive model with a sample size of 350. Chi-Square value = 144,463 with df = 32 and probability 0.000. The Chi-Square results show that the null hypothesis which states the model is the same as empirical data, is accepted which means the model is fit.

### **Hypothesis Test**

Hypothesis testing proposed in this study was done by analysing the value of the Critical Ratio (CR) and the probability of a causal relationship.

**Table 4:** Testing the Research Hypothesis

Variable			Estimate	S.E.	C.R.	P
INN	<---	EO	1.002	1.156	1.011	***
INN	<---	KM	1.032	1.178	1.876	***
INN	<---	DC	1.273	1.132	1.125	***
P	<---	EO	1.444	1.500	1.888	***
P	<---	INN	1.878	1.440	1.997	***
P	<---	KM	4.385	3.823	1.147	***
P	<---	DC	4.628	3.586	1.291	***

**Source:** Primary data processed in 2019

Based on Table 4, hypothesis testing can be explained as follows:

#### **Hypothesis Testing 1**

**H1:** Dynamic capabilities have a positive and significant effect on innovation.

The estimated parameter for testing the effect of dynamic capabilities on innovation shows a CR value of 1.125 with a probability of 0.000. Because the probability value  $< 0.05$ , it can be concluded that the dynamic capabilities variable is proven to be positively and significantly influential on innovation. The results showed hypothesis 1 was tested.

#### **Hypothesis Testing 2**

**H2:** Knowledge management has a positive and significant effect on innovation.

The estimated parameter for testing the effect of knowledge management on innovation shows a CR value of 1.876 with a probability of 0.000. Therefore the probability value  $< 0.05$ , and it can be concluded that the knowledge management variable is proven to be positively and significantly influential on innovation. The results showed hypothesis 2 was tested.

#### **Hypothesis Testing 3**

**H3:** Entrepreneurial orientation has a positive and significant effect on innovation.

The estimation parameter for testing the effect of entrepreneurial orientation on innovation shows a CR value of 1.011 with a probability of 0.000. Therefore the probability value  $< 0.05$ , and it can be concluded that the entrepreneurial orientation variable is proven to be positively and significantly influential on innovation. The results of the research prove that hypothesis 3 is tested.

#### **Hypothesis Testing 4**

**H4:** Dynamic capabilities have a positive and significant effect on SME performance.

The estimated parameter for testing the effect of dynamic capabilities on SME performance shows a CR value of 1.291 with a probability of 0.000. Because the probability value  $< 0.05$ , it can be concluded that the dynamic capabilities variable has a positive and significant effect on the performance of SMEs. The results of the research prove that hypothesis 4 is tested.

#### **Hypothesis Testing 5**

**H5:** Knowledge management has a positive and significant effect on the performance of SMEs.

The estimated parameter for testing the effect of knowledge management has a positive and significant effect on the performance of SMEs, showing a CR value of 1.147 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the knowledge management variable has a positive and significant effect on the performance of SMEs. The results of the study prove that hypothesis 5 is tested.

#### **Hypothesis Testing 6**

**H6:** entrepreneurial orientation has a positive and significant effect on SME performance.

The estimated parameter for testing the effect of entrepreneurial orientation on SME performance shows a CR value of 1.888 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the entrepreneurial orientation variable is proven to be positively and significantly influential on the performance of SMEs. The results of the study prove that hypothesis 6 is tested.

#### **Hypothesis Testing 7**

**H7:** Innovation has a positive and significant effect on the performance of SMEs.

The estimated parameter for testing the effect of innovation on the performance of SMEs shows a CR value of 1.997 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the innovation variable is proven to be positively and significantly influential on the performance of SMEs. The results of the research prove that hypothesis 7 is tested.

### **Hypothesis Testing 8**

**H8:** Dynamic capabilities have a positive and significant effect on SME performance through innovation.

The estimated parameter for testing the effect of dynamic capabilities on SME performance shows a CR value of 1.291 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the dynamic management variable has a positive and significant effect on the performance of SMEs. The estimated parameter for testing the effect of dynamic capabilities on innovation shows a CR value of 1.125 with a probability of 0,000.

The effect of dynamic capabilities on UKM performance through innovation is  $1.291 \times 1.125 = 1.452$ . Based on these results, the indirect effect of 1.452 is greater than the direct effect of 1.291. Therefore, it can be concluded that the innovation variable is proven to be positively and significantly able to mediate between dynamic capabilities and SME performance. The results of the study prove that hypothesis 8 is tested.

### **Hypothesis Testing 9**

**H9:** Knowledge Management has a positive and significant effect on the performance of SMEs through innovation.

The estimated parameter for testing the effect of knowledge management has a positive and significant effect on the performance of SMEs showing a CR value of 1.147 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the knowledge management variable has a positive and significant effect on the performance of SMEs. The estimated parameter for testing the effect of knowledge management on innovation shows a CR value of 1.876 with a probability of 0,000.

The influence of knowledge management on the performance of SMEs through innovation is  $1.147 \times 1.876 = 2.152$ . Based on these results, the indirect effect of 2.152 is higher than the direct effect of 1,147. Therefore, it can be concluded that the innovation variable is proven

positively and significantly mediates between knowledge management and SME performance. The results of the study prove that hypothesis 9 is tested.

### **Hypothesis Testing 10**

**H10:** Entrepreneurial orientation has a positive and significant effect on the performance of SMEs through innovation.

The estimated parameter for testing the effect of entrepreneurial orientation on SME performance shows a CR value of 1.888 with a probability of 0.000. Therefore, with the probability value  $< 0.05$ , it can be concluded that the entrepreneurial orientation variable is proven to be positively and significantly influential on the performance of SMEs. The estimated parameter for testing the effect of entrepreneurial orientation on innovation shows a CR value of 1.011 with a probability of 0.000.

The influence of entrepreneurial orientation on the performance of SMEs through innovation is  $1.888 \times 1.011 = 1.909$ . Based on these results, the indirect effect of 1.109 is higher than the direct effect of 1.010. Therefore, it can be concluded that the innovation variable is proven positively and significantly mediates between entrepreneurial orientation and SME performance. The results of the study prove that hypothesis 10 is tested.

### **Discussion**

Dynamic capabilities, knowledge management and entrepreneurial orientation as the main variable has a major influence on developing an increase in the innovation and the company performance in the SMEs in Indonesia. Now the practitioners will know that for the direct correlation to the company's performance, dynamic capabilities has a greater influence than knowledge management and entrepreneurial orientation factors; this is also in line with what was studied from (Alshanty & Emeagwali, 2019; Avlonitis & Salavou, 2007; Balan & Lindsay, 2010; Subagja et al., 2018), while in the indirect correlation innovation has a greater influence than the dynamic capability, knowledge management and entrepreneurial orientation to the performance of the company. Whilst dynamic capabilities also influence improved SMEs performance, but have smaller factors compared with knowledge management and entrepreneurial orientation. Innovation as a mediation in the relationship of dynamic capabilities, knowledge management and entrepreneurial orientation have a positive and significant performance of SMEs. The marketing innovation indicator provides the biggest contribution.



## **Conclusion**

With this research, we will provide some several contributions to management research and practice. The main contribution of this research to the theory are:

- a. Provide evidence that having the dynamic capability, knowledge management and entrepreneurial orientation of innovation are necessary for achieving superior SME's performance in Indonesia
- b. For direct correlation, the dynamic capabilities, knowledge management and entrepreneurial orientation have a greater influence comparing the other variables, and for indirect correlation (through innovation) has a greater impact to the SME's performance in Indonesia.
- c. Provide the operationalisation of dynamic capability, knowledge management and entrepreneurial orientation and innovation for SME's performance to be used in future research, such as to the others industries' sectors.

Research on small and medium enterprises (SMEs) shows that there is still not much to analyse about dynamic capabilities, knowledge management and entrepreneurial orientation and it's effect on innovation in an effort to improve the performance of SMEs.

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