Innovation and Firm Performance of Small and Medium Enterprises

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ABSTRACT

This research examines the role of innovation power as a strategy that influences firm performance on Small and Medium Enterprises (SMEs) of handmade batik in East Java Region, Indonesia. Handmade Batik is a pictorial fabric that is specially made by writing or putting the parafin on the cloth, then processing is processed in a certain way that has a specificity. Innovation of handmade batik on the creativity of images and patterns that have a fashion value. Innovation is the most important factor to produce a quality product and can improve competitiveness. Companies that have competitive advantage will improve firm performance. Methods of data collection through questionnaires, which consists of 84 respondents. Hypothesis testing is done by path analysis. The findings of this research that innovation is done continuously as a strategy to improve firm performance on SMEs. Companies must be innovative to compete and achieve high performance.

Keywords**:** Innovation; Firm Performance; SMEs; Handmade Batik.

1. INTRODUCTION

SMEs as a form of business managed by individuals, families and community groups, is a business unit in Indonesia that has a resilient resilience in various economic crises. The high or low competitiveness of SMEs is influenced by the ability to innovate. Innovation is an important business factor that can affect a company's competitive advantage, so it can improve the competitiveness of the company. Increased competitiveness of the company will raise the firm performance. Innovation is part of the business strategy undertaken by SMEs to keep the business position in front of, not on the position of followers. SMEs batik handmade tulis as part of small and medium business activities in East Java region, Indonesia, continuously make innovations. Product innovation to produce products that meet consumer needs and changing consumer tastes. Increasingly fierce market competition encourages SMEs batik handmade makers to create new products that have never existed, so that products created have strong competitiveness. In addition to creating new products, the development of existing products into outstanding products must also be done by improving quality, updating shapes, or developing product packaging. In developed countries SMEs can innovate products and process innovation to cope with increasingly diverse and dynamic market demand. Innovation is important for the survival of batik handmade SMEs. Innovation is also a major factor to gain a sustainable competitive advantage in the free market. Gaynor (2002) states that innovation enhances

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organizational growth, controls future success, and is the driving force of business to sustain organizational survival in the global economy. Then, Cho and Pucik (2005) stated that innovation is one of the main factors to improve performance and maintain the company's long-term survival. Organization for Economic Co-Operation and Development (OECD) (2005), classifies innovation into product innovation, process innovation, marketing innovation and organizational innovation. Product innovation is the introduction of new or significantly developed goods and services with respect to the characteristics or usefulness of the goods or services. Process innovation is a new or significantly improved implementation of new and improved production and delivery methods, which includes significant changes in techniques, tools and or software. Marketing innovation is the implementation of new marketing methods that include significant changes in product design or packaging, product placement, product promotion or pricing. Organizational innovation is an innovation of new organizational methods in enterprise business practices, workplace organizations or external relationships.

Most SMEs have made innovations, this is in accordance with the statement (Afuah, 1988) that innovation is more often implemented by SMEs than large companies. SMEs as business entities that are in a dynamic environment, then innovation is a must. High technology industry, research and development intensity, market concentration and export intensity increase further innovation activities in high technology industry. Low technology industries, innovation activities have a positive and significant impact on profitability (Bhattacharya and Harry, 2002). Innovation is a key aspect that leads to competitive advantage.

A number of researchers put forward product innovation and process innovation. Bessant and Tidd (2007) stated that product innovation is a change in the things (products / services) offered by an organization. Later, Francis and Bessant (2005) define process innovation as changes in the way products or services are created and delivered; Cooper (1998) states that process innovation describes changes in the way organizations produce products and end services of a company. Furthermore, Griffin (2013) describes the possible forms of innovation for SME actors, including: product innovation and process innovation. Product innovation is a change in the characteristics or performance of an existing product or service, or the creation of an entirely new product or service. Process innovation is a change in the way products and services are created, created, and distributed.

Many studies on product innovation and process innovation, because the two types of innovation considered exactly implemented in SMEs batik handmade belonging to the fashion industry. In addition, in accordance with the statement of Atalay et al., (2013) stating that product innovation and process innovation are needed to strengthen the competitiveness of SMEs in the face of increasingly fierce competition. Then, the definition of innovation used in this study refers to the definition of product innovation and process innovation proposed by Griffin (2004), OECD (2005), Bessant and Tidd (2007). Product innovation is defined as the development of new goods and services by considering the characteristics or usefulness of the goods or services or the creation of an entirely new product or service. Process innovation as implementation of changes in the way organizations create products and deliver services.

The increase or decrease in the company's performance depends on the company's ability to compete with other companies, the consumer's response to the products or services produced by the company, so that the innovation strategy undertaken will have

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an influence on the ups and downs of the company's performance. Atalay et al., (2013) which states that product innovation and process innovation are needed to strengthen the competitiveness of SMEs in the face of increasingly fierce competition. Han, et al., (1998), Salavou and Avlonitis (2008), Neira, et. al. (2008) and Najib and Kiminami (2011) suggest that there is an influence between innovation (product innovation and process innovation) on firm performance as measured by return on assets, and the high or low level of profit gained by the type of strategy change implemented.

In this study is the performance of the company or business performance is the financial performance achieved in the form of achievements of the financial aspects by SMEs. Firm performance is the level of success of the company in achieving its goals through the use of various resources it has. Both the poor performance of the company is strongly influenced by the company's ability to use its resources and adapt to the changing conditions of innovation. Jaugh and Glueck (1998) stated that the measurement of the company's performance can be seen from the level of sales, profitability, return on capital, turnover rate, and market share. The company's performance in this study is measured by the level of production indicator, the market share achieved by the high sales volume and the profitability of the SMEs obtained.

2. LITERATURE REVIEW

Rogers (2003) views innovation as a process that begins with the creation of new elements, with the creation that directs the idea of practical development on an element for commercial use. Furthermore, Rogers (2003) defines innovation as an idea, practice, or object considered new by individuals or other adoption units. This theory believes that an innovation diffuses throughout society in a predictable pattern. Some groups of people will adopt an innovation after they hear the innovation, some other community groups take a long time to adopt the innovation. When an innovation is widely adopted by a number of people, it is said to be exploded or exploded.

Another author of innovation literature, Gaynor (2002) states that innovation begins with an idea that is converted into a concept. Innovation is a new combination of what already exists and can be implemented for a number of purposes. Another notion of innovation is the implementation of new products or significantly upgraded products, processes, new marketing methods, or new organizational methods in business practices, workplace organizations or external relations (OECD, 2005). So the requirement is said innovation is product, process, method of marketing and organization method must be new or significantly enhanced for company.

Firm performance is a description of the financial condition of a company that is analyzed with the tools of financial analysis, so it can be known about good bad financial condition of a company that reflects the performance of work within a certain period. It is very important that resources are used optimally in the face of environmental change. Assessment of corporate performance is one way that can be done by the management in order to fulfill its obligations to the funders and also to achieve the goals set by the company. Firm performance is an indicator of both the poor management decisions in decision making. Management can interact with both external and external environments through information. The information is further poured or summarized in the company's financial statements. Firm performance by Lee and Tsang (2001) is measured by sales growth, asset growth, and business profit growth. The company's performance measurement can be measured by the level of sales,

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profitability, payback, turnover rate, and market share (Jaugh and Glueck, 1998). Several studies have examined the performance of SMEs. Camison and Ana (2010) measure the performance of small and medium enterprises with reference to three aspects, namely profitability, productivity, and market. While Lee and Tsang (2001) assess business performance through venture growth consisting of sales growth, asset growth and business profit growth. Relevant measure of financial performance in this study at the level of production, market share and profit rate.

There is a relationship between innovation and firm performance revealed by Han, et al., (1998), Salavou and Avlonitis (2008), Neira, et. al., (2009), Najib and Kiminami (2011) suggest that there is an influence between innovation (product innovation, process innovation and marketing innovation) firm performance as measured by return on assets, and the high or low rate of returns derived based on the type of change being implemented. Innovations in high industries have an influence on performance by Bhattacharya and Bloch (2002) examining the difference in innovation activities in high technology and low technology in Small and Medium Manufacturing. The result of research stated that in high technology industry, research and development intensity has a significant positive effect on innovation activity. Cheng and Chun (2005) research results show that there is a non linear relationship between innovation and firm performance. Li, et al., (2006) examined the impact of human resources management on technological innovation and organizational performance. Innovations with variable dimensions of product innovation and process innovation have an influence with business performance. This is stated by Rosli (2013) conducted a study to analyze the influence of various dimensions of innovation on the performance of SMEs. The results stated that product innovation and process innovation have a significant positive effect on SME performance. Similarly, stated by Ismanu, et al., (2017), innovation with dimensions of product innovation and process innovation that have a significant influence on financial performance of SMEs. Financial performance as part of firm performance. Based on the description above, can be expressed a hypothesis:
H1. innovation has a positive and significant impact on firm performance of SMEs.

2.1. Conceptual Research Framework

The conceptual framework of the study explains the relationship between innovation variables and dimensions (product innovation and process innovation), then each dimension with indicators (X11, X12, X13, X14, X21, X22, X23, and X24). The relationship between firm performance variables and indicators (Y1, Y2, and Y3). The relationship innovation and firm performance, presented in Figure 1 below.

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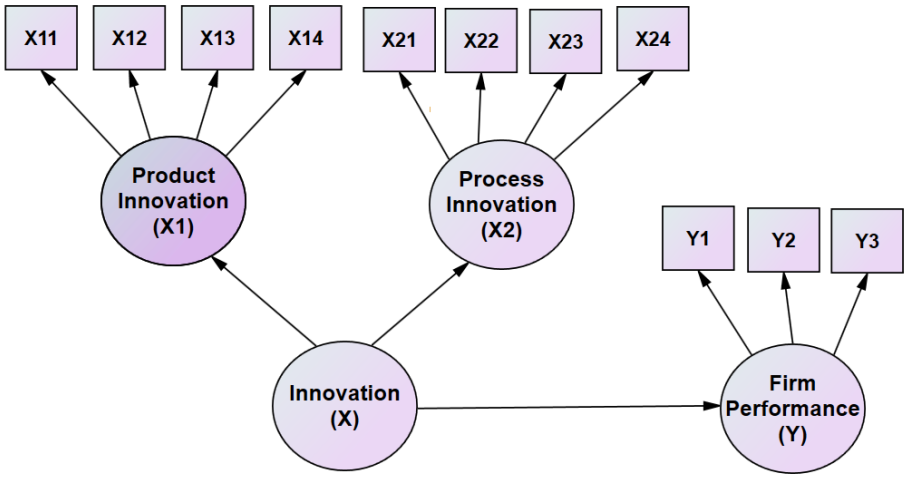

Figure 1. Conceptual framework of the study

3. RESEARCH METHODS

The analysis technique used in this research is Structural Equation Model (SEM). Measurement model or measurement model to confirm indicators of a latent variable as well as a structural model that describes the causality relationship between two or more variables. Convert the path diagram into the system of equations. The system of equations that shows the relationship between latent variables (inner model) and the relationship indicator with the variable (outer model).

Variable innovation (X) is reflective second order:

First level: $X1 = \beta1\ X + \varepsilon1$, $X2 = \beta2\ X + \varepsilon2$.

Second level: Product innovation (X1): $X11 = \beta3\ X1 + \varepsilon3$, $X12 = \beta4\ X1 + \varepsilon4$, $X13 = \beta5\ X1 + \varepsilon5$, $X14 = \beta6\ X1 + \varepsilon6$.

Process innovation (X2): $X21 = \beta7\ X2 + \varepsilon7$, $X22 = \beta8\ X2 + \varepsilon8$, $X23 = \beta9\ X2 + \varepsilon9$, $X24 = \beta10\ X2 + \varepsilon10$.

The firm performance variable (Y) is reflective: $Y1 = \beta11Y + \varepsilon11$, $K2 = \beta12Y + \varepsilon12$, $K3 = \beta13Y + \varepsilon13$.

The structural equation model is as follows: $Y = \beta14 + \beta15X + \varepsilon14$

3.1. Operational Definition of Variables

Tabel 1. Operations of Innovation Variable

Dimension	Indicators	References
Product Innovation (X1)	1) Variety of products (X11) 2) Product excellence (X12) 3) Up to date products (X13) 4) Product made from batik cloth (X14)	1) Atalay, et.al., (2013) 2) Rosli and Sidek, (2013) 3) OECD, (2005)
Process Innovation (X2)	1) New method of production process (X21) 2) Supporting activities (X22) 3) Effective and efficient (X23) 4) New method of product delivery (X24)	

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Tabel 2. Operations of Firm Performance Variable

Indicators	References
1) Production level (Y1) 2) Marketing (Y2) 3) Profit growth (Y3)	1) Dess, G.G. and Berd, D.W, (1984) 2) Lee, D.Y. and Tsang, E.W.K, (2001) 3) Camison, C. And Ana, V.L., (2010)

4. Results and Findings

Instrument test is required to test the validity and reliability of indicator items. Validity test is used to test the accuracy of the measuring instrument. Validity testing is done by using product moment correlation formula (r_{xy}). Measuring tool is valid if the value of rhitung (r_{xy}) is greater than table value (r_{tabel}). In this study the number of respondents (n = 84) with 5% significance level found r_{tabel} = 0.220, status item indicator valid if $r_{xy} > r_{tabel}$, and item indicator is invalid if $r_{xy} < r_{tabel}$.

Prior to the validity and reliability test, the operational variables that are presented on the question form submitted to the respondents of the owner or manager of batik handmade SMEs in East Java Region, Indonesia. Innovation variable as exogenous variable with 8 item indicator, and firm performance as endogen variable with 3 item indicator. Each variable and its indicator items are shown in the table below.

The results of validity testing can be seen in the following table.

Tabel 3: Test the validity of Innovation indicator item (X)

Indicator Items	r_{xy}	r_{tabel}	Status
X11	0.461	0.220	Valid
X12	0.422	0.220	Valid
X13	0.398	0.220	Valid
X14	0.295	0.220	Valid
X21	0.483	0.220	Valid
X22	0.607	0.220	Valid
X23	0.654	0.220	Valid
X24	0.627	0.220	Valid

Tabel 4: Test the validity of Firm Performance indicator items (Y)

Indicator Items	r_{xy}	r_{tabel}	Status
Y1	0.700	0.220	Valid
Y2	0.484	0.220	Valid
Y3	0.604	0.220	Valid

Reliability test is used to test the reliability of a measuring instrument to be used again for the same research. Reliability testing in this research is by using Cronbach Alpha formula. Measurement tool is said to be reliable if all variables have value above coefficient Alpha Cronbach. In this study the number of respondents (n=84) with a significance level of 5% found the value of r_{tabel}=0.220, and Cronbach Alpha value is calculated as 0.894. Then the value is compared with the value of r_{tabel} with Cronbach Alpha value. The result is Alpha Cronbach>r_{tabel}, meaning that indicator items can be said reliably or reliably as a tool for collecting research data.

4.1. Hypothesis Model

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Assessing the results of the structural model test (inner model) can be seen in R-square (R^2) in each endogenous construct (innovation and firm performance), path coefficient, t and p values of each path relationship between constructs. The value of path coefficient and t value on each path will be explained in the sub-discussion of hypothesis testing result. The value of R^2 is used to measure the degree of variation in the endogenous variables described by a number of influencing variables (Hair et al, 2010). The higher the value of R^2 means the better the predicted model of the proposed model. The higher the value of R^2 means the predicted contribution of the influence of exogenous variables on the endogenous variable is greater.

Loading factor is a large correlation between the indicator and its latent construct. In many social studies, the measurement of a construct is very often done indirectly through its indicators. Indicators with high loading factors have a higher contribution to explain their latent constructs. Conversely, the indicator with low loading factor has a weak contribution to explain its latent construct. In most references a factor weight of 0.50 or more is considered to have strong enough validation to explain latent constructs (Hair et al, 2010).

Tabel 5: Loading Factor and Crossloading

Item	Product Innovation	Process Innovation	Firm Performance
X1	**0.757**	0.054	0.117
X2	**0.852**	0.366	0.376
X3	**0.760**	0.272	0.347
X4	**0.666**	0.443	0.292
X5	0.339	**0.742**	0.348
X6	0.286	**0.891**	0.447
X7	0.295	**0.798**	0.450
X8	0.492	**0.790**	0.553
Y1	0.325	0.471	**0.889**
Y2	0.339	0.476	**0.912**
Y3	0.478	0.581	**0.928**

Following Table 5, the loading factor results explain that all items used have high validation as the explanation of each construct. The loading factor coefficient of each item in the other construct is lower than the loading factor of the construct in question.

In addition to the validity test, a measurement model is said to be good if it has a sufficient level of reliability. A construct is said to be reliable if the coefficient value of cronbach's alpha is greater than 0.70, but a value of 0.60 is still acceptable for exploratory research (Hair et al., 2010). The reliability of the measurement model can also be judged by the large coefficient of composite reliability, including in either category if the coefficient reaches 0.70 or more.

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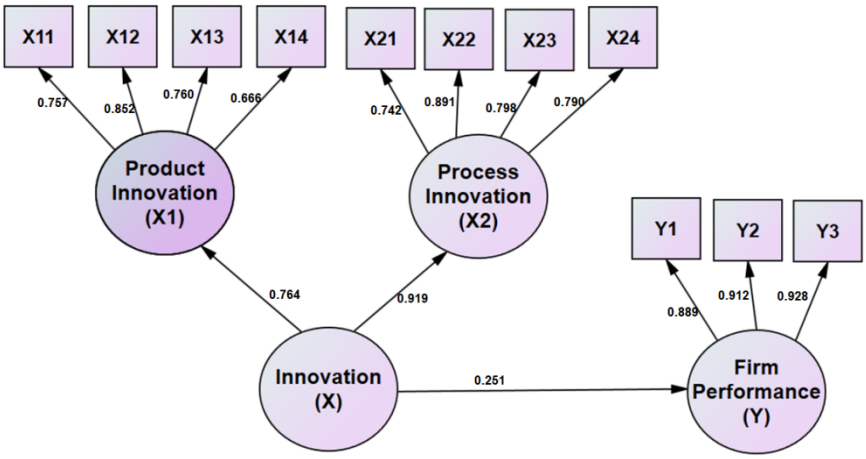

Figure 2. Relationship of Innovation and Firm Performance

The result of analsis relationship between variables in research by using smartPLS looks like in Figure 2. Based on the drawing of the result of inner model of Figure 2 above, the result of the path coefficient test on the inner model of the relationship between exogenous variables of innovation and performance companies as endogenous variables. Overall analysis is presented in Table 6.

Table 6: Result of Line Coefficient Test on Inner Model

Relationship	Path coefficient	Standard Deviation	t Statistic	P
Variable with Variable:				
Innovation → Firm Performance	0.251	0.119	2.102	0.036
Variable with Dimensions:				
Innovation → Product Innovation	0.764	0.059	12.998	0.000
Innovation → Process Innovation	0.919	0.019	47.752	0.000

Innovation on firm performance has coefficient with positive direction. The calculation results show that the path coefficient of 0.251 with t-statistics of 2.102 ($p < 0.05$) gives the decision that innovation has a significant effect on firm performance. The level of corporate innovation can be measured from products and processes. High innovation within the firm will improve the firm performance.

4.2. Influence of Innovation on Firm Performance

In the increasingly fierce business competition, all entrepreneurs who jumped in the field of business, both products and services competing each other to be the best in order to produce products in accordance with consumer demand. Then, every time new competitors with new business and product models keep emerging. Therefore, the entrepreneur must be able to respond and innovate so that his business has a competitive advantage and can survive. Innovations undertaken by SMEs produce high value and are done on an ongoing basis will be decisive in entering the market and becoming the market leader. In addition, innovation is done as an appropriate solution to get out of the saturation of a product, so that consumers increasingly have many options to use products that are practical and as needed. Consumers are willing to pay a higher price for an innovation and will increase the profit of SMEs.

Innovation is the most important way for companies to create new value for customers and to be a competitive advantage and innovation will have an impact on the

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success of the company. Innovation is an important function in management, because innovation is related to firm performance. The results of analysis on the effect of innovation on the performance of the company shows that innovation has a positive role in improving the performance of the company where the higher the power of innovation will be the higher firm performance of batik SMEs at East Java region, Indonesia.
Further test results in the interpretation that the owner of batik SME batik at East Java is able to develop the power of creativity by realizing innovations, especially on product innovation and process innovation.

Innovation as a corporate mechanism to adapt to a dynamic environment, there is a demand to be able to create new thoughts, new ideas by offering innovative products and improved service that can satisfy customers. Two innovation concepts he proposes are innovation and innovation capacity. Innovation is the idea of openness to new ideas as aspects of corporate culture, while the capacity to innovate is the company's ability to use or apply new ideas, processes / new products successfully.

Han et al., (1998) argued that innovation is not only focused on technical issues but also related to aspects of organizational administration. The emergence of product innovation is basically to meet market demand, so that product innovation is one that can be used as a competitive advantage for the company. Product innovation positively and significantly affects firm performance, but product innovation can also serve as a mediator that strengthens the relationship between market orientation and firm performance.

The performance of the organization depends essentially on the harmony of technical innovation (product innovation and process innovation) and administrative innovation (business governance). Technical innovation deals with basic work activities that can directly affect the product or process. Administrative innovation is an innovation that is not directly related to the organization's basic activities. Eg the use of computers to do bookkeeping. In general, in East Java-Indonesia batik SMEs, innovation measurements can be reviewed in product innovation and process innovation.

On the other hand, product innovation as a process of using new technology into a product so that the product has added value. Innovation can be done on goods, services, or ideas received by someone as something new, so maybe an idea has emerged in the past, but can be considered innovative for new-found customers.
The increasing number of goods offered to consumers and supported by the flow of information about the products that are easily obtained, causing them to be more selective in buying an item, both in quality, design style, color and price.

Product innovation aims to maintain the viability of the company, as existing products are vulnerable to changing consumer needs and tastes, technology, shorter product life cycles, and increased domestic and foreign competition. Product innovation must be done through the results of market research, so as to produce products in accordance with consumer tastes. Although the company is concerned with quality, but if the company does not pay attention to the tastes of consumers, it will cause the product is not interested, even consumers will switch to other products, so sales will fall. Product innovation will add value compared to similar products (product excellence), so it will increase sales. The competitive advantage of a product is one of the determinants of the success of a new product, so that an innovation product must have an advantage over other similar products. This is also in line with Cooper (1998) 's opinion that the benefits of new products are very important in a highly competitive global market environment. These advantages can not be separated from the

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development of product innovation is produced so that will have an advantage in the market which will then win in the competition. Product innovation can produce a new or distinctive product, it is revealed by Li and Calantone (1998), argues that the uniqueness of a product is defined as an important attribute of the product's superiority, which is influenced by innovative power and high technology, with consumer tastes. The success of the company's business will be achieved if the company can quickly react to new market conditions and customer needs. In addition the company can continuously seek creative solutions as well as continuous improvement in producing the products.

Innovation of SME batik handmade products East Java region is manifested in a variety of batik fabrics with various motifs typical of the region, and other complementary products such as pillowcases, dolls, tissue box wrap.

Process innovation is a new element introduced in the operation of products and services within the company, such as material materials, task specifications, mechanisms, or equipment used to manufacture products or provide services. Johne (1999) process innovation provides the means to maintain and improve quality and to save costs. Francis and Bessant (2005) argue that process innovation as a change in the way products or services are created and delivered. Cooper (1998) states that process innovation describes changes in the way organizations produce products and end services of a company. Process innovation is needed to improve productivity levels related to increasing job satisfaction for workers, improving product delivery or service value to customers, monitoring and reducing wasted products, monitoring and reducing products in the process, and reducing processing time and costs.

5. CONCLUSION

Innovating as an implementation of new ideas and ideas, especially on product innovation and process innovation is the most important way for batik handemade SMEs in East Java region, Indonesia. Its innovation to create new value for customers and become a competitive advantage and innovation will have an impact on increasing sales. Innovation is an important function in strategy management, because innovation is related to firm performance. The result of analysis on innovation strategy conducted by batik handmade by producing motifs and patterns and other products such as bags, shoes, place of tissue made from batik cloth, and increasing efficiency of production process can increase profit. It shows that innovation has a very important role in the management of a business to be able to improve firm performance.

Based on the results of this study, for further research is expected to the owner of batik handmade in improving firm performance, it is advisable: changes in the innovation must be addressed proactively by creative thinking and innovative behavior by finding new ideas, ide creative and implements to innovation effectively and efficiently.

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