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### THE ROLE OF INNOVATION IN MEDIATING THE EFFECTS OF MARKET ORIENTATION AND ENTREPRENEURIAL ORIENTATION ON BUSINESS PERFORMANCE IN THE CONTEXT OF SMES

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#### **ABSTRACT:**

The aims of this study are to examine and analyse the role of innovation in mediating the effect of market orientation and entrepreneurial orientation on business performance in the context of small and medium size enterprises (SMEs). The results showed that market orientation and entrepreneurial orientation proved to have a positive and significant effect on business performance. An interesting result of this study is that that innovation plays a role as a mediator in the influence of market orientation and entrepreneurial orientation on business performance in the context of SMEs. Nevertheless, the mediating role of innovation in determining the magnitude of the influence between market orientation and entrepreneurial orientation on business performance is smaller than the direct influence. Overall, the results of this study indicate that a combination of market orientation and entrepreneurial orientation are the instruments that underlie SMEs in shaping innovation so as to improve business performance in the context of SMEs.

#### **INTRODUCTION:**

The business environment and customer preferences always change to be more dynamic and complex. To deal with changes in the business environment and changes in customer preferences, many large companies and SMEs adopt the idea of market orientation. Narver and Slater (1990) define market orientation

as a culture related to the fundamental characteristics of an organization such as customer orientation, competitor orientation, and coordination between functions, which are operationalized in employee behavior. While, Kohli and Jaworski (1990) define it as organizational behavior, such as: obtaining information about the needs of current and future customers; dissemination of information to all parts of the company to obtain strategic synergies; and respond to information that comes from all parts in the form of marketing strategies that are in accordance with the existing market environment). Companies will get better performance when companies try to focus on market orientation with special emphasis on flexibility and faster response (Baker and Sinkula, 1999; Hardley and Mavondo, 2000; Benito et al., 2009)

Although market orientation-business performance relations have become the focus of many studies, a synthesis for existing findings to better understand this relationship in the context of SMEs have been virtually nonexistent (Raju et al., 2011). Several studies show that there are several major differences between SMEs and larger organizations (Acs and Audretsch, 1987; Coviello et al., 2000), as well as the role of market orientation is quite different in the context of SMEs. Firm size is an important consideration with respect to the competitive advantage of an organization. The medium-sized companies can behave differently from smaller companies in terms of strategic orientation and innovation (Laforet, 2009). SMEs also tend to be intrinsically more innovative, especially in the early stages of an industry's life cycle (Acs and Audretsch, 1987; Audretsch, 2002). Small companies also tend to have more contact with customers (Coviello et al., 2000); greater tendency for action (Chen and Hambrick, 1995); and higher output flexibility than large companies (Fiegenbaum and Karnani, 1991).

Besides that, there is bias measurement of market orientation itself. The market orientation measurement scale known so far has been constructed for a larger organizational context. Another limitation of the current market orientation scale is that the measurement scale emphasizes individual market orientation dimensions which are likely to be detrimental to SMEs in the sense that these dimensions might underestimate the level of market orientation for SMEs. Chances are SMEs view market orientation as a mix of all dimensions and do not emphasize each dimension separately. Market orientation measurements designed for larger organizations, are unlikely to be suitable for measuring market orientation in the context of SMEs (Raju et al., 2011).

In addition, researchers' attention to strategic marketing in the context of SMEs usually cannot be separated from entrepreneurial orientation. Entrepreneurial orientation is considered to involve aspects of entering a new market (Lumpkin & Dess, 1996). This is consistent with the conceptualization of Slater and Narver (1993 and 1995) which proves that entrepreneurial values increase the creation of new businesses in existing businesses and renewal for sustainable businesses that have stagnated and require transformation. Entrepreneurial orientation becomes an important construct, especially in relation to business performance. Conceptually, the higher the entrepreneurial orientation will produce high business performance (Covin and Slevin (2006); Wilkund (1999); Chow (2006); Atuaheme-Gima and Ko (2001).

On the other hand, one of the key components in the success of an industry is the extent to which innovation is carried out. Innovation is related to the company's capacity to be involved in innovation; that is, the introduction of new processes, products, or ideas in the organization. Innovation is one of the most important factors and has an impact on business performance (Hurley, Hult, & Tomas, 1998; Porter, 1990). Some studies also support the mediating role of innovation in determining organizational performance (Atuahene-Gima, 1996; Han et al., 1998; Langerak et al., 2007; Lukas and Ferrell, 2000).

In today's competitive environment, innovation is generally regarded as the company's capacity in creating competitive core values and one of the most important competitive weapons (Sandvik and Sandvik, 2003). Innovation is also not only needed for large companies, but also for small and medium enterprises (Jong and Vermeulen, 2006). There are several findings in SMEs research that use innovation as a mediator of business-market-performance relationship. The ability to introduce unique products and a combination of market orientation and product innovation has proven to contribute to superior performance in SMEs (Avlonitis and Salavou, 2002). Low et al. (2007) proved a positive correlation between market orientation and innovation, and between innovation and company performance. The findings of Laforet (2009); also prove that firm size, strategic orientation, and market orientation are associated with innovation in the context of SMEs.

## **LITERATURE REVIEW**

### ***Market Orientation***

The concept of marketing and market orientation is seen as one of the focus of marketing management to articulate the strategies developed. Most businesses give priority to identifying whether the company is market oriented or not. The results of the research by Narver and Slater (1990), Jaworski and Kohli (1993) show that market orientation is a company effort to always produce products/services in accordance with market/consumer needs. Market orientation will encourage companies to innovate at all times. Research on market orientation has increased significantly since 2001 and has been stable in recent years based on the findings of Liao et al. (2011) who conducted a comprehensive survey of market orientation research published in 1995-2008, but efforts to synthesize existing findings to better understand this relationship in the context of smaller organizations (SMEs) have not been many (Raju et al., 2011). Firm size is an important consideration with respect to the competitive advantage of an organization. The results of the meta-analysis of Raju et al. (2011) support a positive (direct or indirect) relationship between market orientation and business performance.

### ***Entrepreneurial Orientation***

The importance of entrepreneurship for a company's strategic management has been widely recognized in the strategy management literature. Previous theories and research have suggested that entrepreneurial orientation is the key to organizational success. Entrepreneurial orientation can be considered as

involving aspects of entering a new market, especially how to enter the new market (Lumpkin & Dess, 1996). Slater and Narver (1995) show that entrepreneurial values increase the creation of new businesses in existing businesses and renewal or the rise of sustainable businesses that have stagnated or need transformation. Entrepreneurial orientation shows a tendency towards the creation of new products, effort, activity and competitive aggressiveness that embody action-oriented competitive positions (Cooper & Dunkelberg, 1986; Cooper, Woo & Dunkelberg, 1989). Thus, entrepreneurial orientation is characterized by courage and risk tolerance in entering new markets (Naman & Slevin, 1993; Lumpkin & Dess, 1996).

### ***Innovation***

Innovation is a means to change an organization, whether as a response to changes that occur in the internal or external environment or as a preventive measure taken to influence the environment. Because the environment evolves, companies must adopt innovations over time and the most important innovations are those that enable companies to achieve a kind of competitive advantage, thereby contributing to performance (Damanpour, 1991). Innovation is related to the company's capacity to be involved in innovation; that is, the introduction of new processes, products, or ideas in the organization. Product innovation in a manufacturing company is a strategic configuration where the company truly adapts to the environment through the development of new products (Manu and Sriram (1996). Effect of product innovation on business performance It has also become one of the important issues in the literature, from a positive point of view, product innovation is a solution provider to market threats and opportunities, creating a basis for the survival and success of a company in the future (Hult et al., 2004). On the other hand, product innovation is an expensive and risky activity (Simpson et al., 2006).

### ***Business Performance***

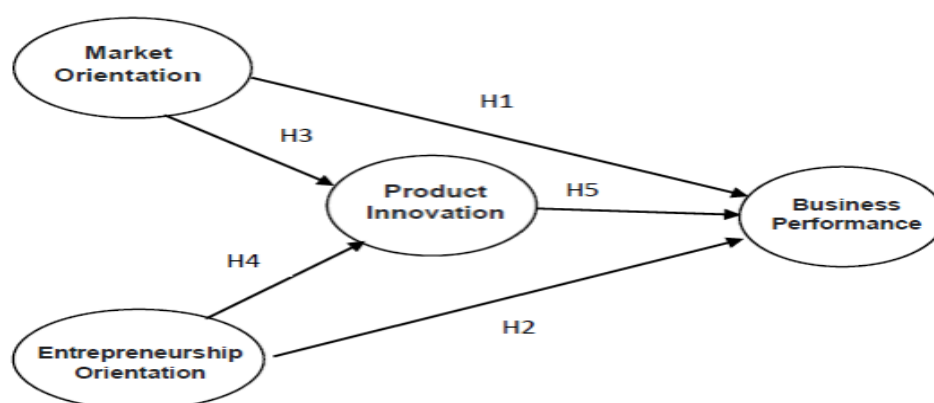
Business performance is one of the important concepts in management research. Good business performance will affect the survival of the company. Business performance is defined as the rate of sustainable income for several years (Porter, 1980). Most of the research on performance measurement comes from organizational theory and strategy management (Murphy et al., 1996). Venkatraman and Ramanujam (1989) have shown that the company's performance is a multidimensional construct. Strategists view organizational performance as three broader sequential constructs. There are three perspectives on organizational performance. First, a narrower perspective on organizational performance is financial performance. Second, according to a broader perspective, organizational performance is a business performance that includes operational performance and financial performance. Third, is the broadest perspective, namely organizational performance is effectiveness.

### *Hypothesis*

The hypothesis in this study:

- H1:** Market orientation has a positive effect on business performance.
- H2:** Entrepreneurial orientation has a positive effect on business performance.
- H3:** Market orientation has a positive effect on business performance through mediation of product innovation.
- H4:** Entrepreneurial Orientation has a positive effect on business performance through mediation of product innovation.
- H5:** Product innovation has a positive effect on business performance

### *Research model*



**Figure1.** Research Model

## **RESEARCH METHODS**

### *Research Design*

This study uses a quantitative approach; primary data obtained directly from research sources; and using survey methods. Data obtained by submitting questionnaires directly to respondents. This research is a cross sectional study because data collection is only done once (Cooper and Schindler, 2003). The unit of analysis in this study is Small and Medium Enterprises. The population are Small and Medium Enterprises (SMEs) in the province of Yogyakarta Special Region (DIY), Indonesia. The sampling method is non-probability sampling with convenience sampling technique. While the number of samples taken was 187 creative SMEs owners (fashion), such as batik SMEs, woven fabrics, silver handicrafts, and leather crafts owners. The method of analysis carried out in this study uses Structural Equation Modeling (SEM) with Maximum Likelihood (ML) estimation based on covariance matrices which is applied through the AMOS (Analysis of Moment Structure) program Version 21. This method of analysis it is used because it focuses on theoretical testing (a strong theory-based model) by emphasizing structural relationships, and is able to simultaneously combine measurement models and structural models (Hair et al., 2006). The sample size for ML estimation is at least 5 X the number of parameters in the model, including errors (Bentler & Chou, 1993). Based on

this, the rule of thumb of the sample size required in ML is at least 100-200 cases.

### *Measurement of variables*

In this study, market orientation is defined as a culture that is owned by small and medium businesses that show behavior in delivering superior value to buyers so as to produce superior business performance. Many methods have been previously declared, but many of these methods include methods from Kohli and Jaworski (1993) known as MARKOR and Narver and Slater (1990) known as MKTOR. There are at least twenty-six methods that have been used to measure market orientation. The main advantages and disadvantages of each method have been reviewed by Tomášková (2009). Although there are many market orientation measurement models that have been developed by different experts, the most widely used are the MKTOR models introduced by Slater and Naver (1993). Based on previous research studies on the relationship of market orientation to business performance, this study apply Raju et al. (2011) which supports a market orientation view that consists of four dimensions, three dimensions of the MARKTOR scale (Narver and Slater, 1990), such as customer orientation (X1.1); competitor orientation (X1.2); coordination between functions (X1.3); and supplemented by one dimension of "responsiveness to market intelligence (X1.4)" of the scale MARKOR (Kohli and Jaworski, 1990). In addition, one dimension of "social benefit orientation (X1.5)" was added from the NEWMKTOR scale, developed by Gunarathne (2015) which is a further development of the MKTOR model (Narver and Slater (1990). While today most people both customers and businesses tend to pay attention to social benefits. Entrepreneurial orientation is defined as a process, structure and behavior of a company that is characterized by innovation, proactive and risk taking (Covin and Slevin, 1989). In this study the measurement of entrepreneurial orientation variables compiles the instruments used by Wilkund (1999) based on the results of Miller's (1983) study: innovation (X2.1), proactive (X2.2), and risk taking (X3.3). Product innovation in this study adopted the concept in manufacturing companies as a strategic configuration of how companies really adapt to their environment through the development of new products (Manu and Sriram, 1996). According to Peters (2000) and Manu and Sriram (1996), there are 3 items to measure product innovation by measuring the input of innovation and output of innovation. The first two items, which measure innovation output are based on Baker and Sinkula (1999a), such as: the number of new product introductions (Y1.1) and the uniqueness of new product introductions (Y1.2). The third item measures input innovations such as the concept of the concept of intensity of innovation (Peters, 2000) and commitment to innovation (Schoenecker et al., 1995), and is operationalized as a financial company and other resources dedicated to research and development (Y1.3). Business performance in this study is the results obtained by the company from the activities that have been carried out over the past three years. The business performance used in this study was measured comprehensively using both financial and non-financial perspectives by adapting the size of Camison (2004) in Sances & Marin (2005) using 3 aspects, namely: profitability (Y2.1), productivity (Y2.3), market (Y3.3).

## RESULTS AND DISCUSSION

### *Confirmation Factor Analysis (Confirmatory Factor Analysis)*

After all assumptions of using SEM analysis are fulfilled, the next step is to measure each construct to assess unidimensional and construct reliability. Evaluation of measurements for each construct is done with Confirmatory Factor Analysis (CFA). CFA is used to examine variables that define a construct that cannot be measured directly; aims to confirm whether the indicator really measures other variables; to find out the relationship between constructs and indicators; and analysis of research indicators will give meaning to a construct or latent variable to be confirmed. Based on the results of the Confirmatory Factor Analysis (CFA) in **Table 1**, shows that all indicators of market orientation, entrepreneurial orientation, product innovation and business performance variables have loading factors above 0.4, CR values in above 1.96 and the probability value is below 0.05. Thus, all indicators have good validity, meaning that each indicator precisely measures the variables of market orientation, entrepreneurial orientation, product innovation and business performance.

**Table 1.** Variable Evaluation of Market Orientation, Entrepreneurial Orientation, Product Innovation, And Business Performance

Indicator		Variabel	Loading Factor	C.R	Sig.
X <sub>1.5</sub>	<-----	Market orientation	0,525	3,920	0,000
X <sub>1.4</sub>	<-----	Market orientation	0,625	3,856	0,000
X <sub>1.3</sub>	<-----	Market orientation	0,635	3,740	0,000
X <sub>1.2</sub>	<-----	Market orientation	0,790	3,277	0,000
X <sub>1.1</sub>	<-----	Market orientation	0,445	Fix	
X <sub>2.3</sub>	<-----	Entrepreneurial Orientation	0,604	4,966	0,000
X <sub>2.2</sub>	<-----	Entrepreneurial Orientation	0,754	4,909	0,000
X <sub>2.1</sub>	<-----	Entrepreneurial Orientation	0,687	Fix	
Y <sub>1.3</sub>	<-----	Product innovation	0,686	4,080	0,000
Y <sub>1.2</sub>	<-----	Product innovation	0,603	4,183	0,000
Y <sub>1.1</sub>	<-----	Product innovation	0,622	Fix	
Y <sub>1.3</sub>	<-----	Business Performance	0,555	4,704	0,000
Y <sub>1.2</sub>	<-----	Business Performance	0,686	5,010	0,000
Y <sub>1.1</sub>	<-----	Business Performance	0,846	Fix	

### *Construct Reliability Test and Variance Extracted*

After testing the factor loading indicator significance, then the construct will be evaluated by assessing construct reliability. The assessment of unidimensionality and reliability is carried out to determine whether or not the

degree of suitability of an indicator is in explaining one dimension to a model. Unidimensionality is an assumption used in calculating reliability. Reliability is a measure of the consistency of an indicator in identifying a construct. There are two ways used to measure the reliability is to look at construct validity and variance extract. The boundary value used to determine whether an indicator is able to explain one dimension in a model is 0.7 while the recommended extracted variance value is at least 0.50 (Ferdinand, 2014). Summary of the results of construct reliability and variance extracted from each variable can be presented in **Table 2**.

**Table 2.** Construct Reliability Test and Variance Extracted

<b>Variable</b>	<b>GFI</b>	<b>Contract Reliability</b>	<b>Variance Extracted</b>	<b>Description</b>
Market orientation	1.000	0,756	0,520	Valid Unidimensional and Reliable
Entrepreneurial Orientation	1.000	0,814	0,595	Valid Unidimensional and Reliable
Product innovation	1.000	0,770	0,529	Valid Unidimensional and Reliable
Business Performance	1.000	0,827	0,621	Valid Unidimensional and Reliable

Based on the data in the **Table 2** above it can be said that the construct validity and variance extract values in this study meet the required limits. Therefore, it can be concluded that the indicators used as observed variables are able to explain the latent variables that are formed.

#### ***Model Suitability Assessment (Goodness of Fit)***

Based on the estimation results obtained from the measurement model shows that the measurement model is stated to have unidimensionality, and the constructs used have good reliability. Even so, the assessment of the suitability of the structural model (structural model fit) will be carried out from the causality relationship between the variables built. The variables in this study are grouped into two types, namely exogenous variables or variables whose values are determined outside the model and endogenous variables or variables whose value is determined by the equation or from the model of the relationship formed. To assess whether a model is fit or not, an overall model test (full model test) is carried out. The model is said to be good when the development of the hypothetical model proposed theoretically is supported by empirical data. Through the SEM model, it will be seen whether there is a model suitability of the causality relationship built in the model being tested. Thus, the conformity assessment of the structural model conducted aims to evaluate the suitability of the observation or actual input (covariance matrix) with predictions from the proposed model (proposed model). This assessment is carried out based on the

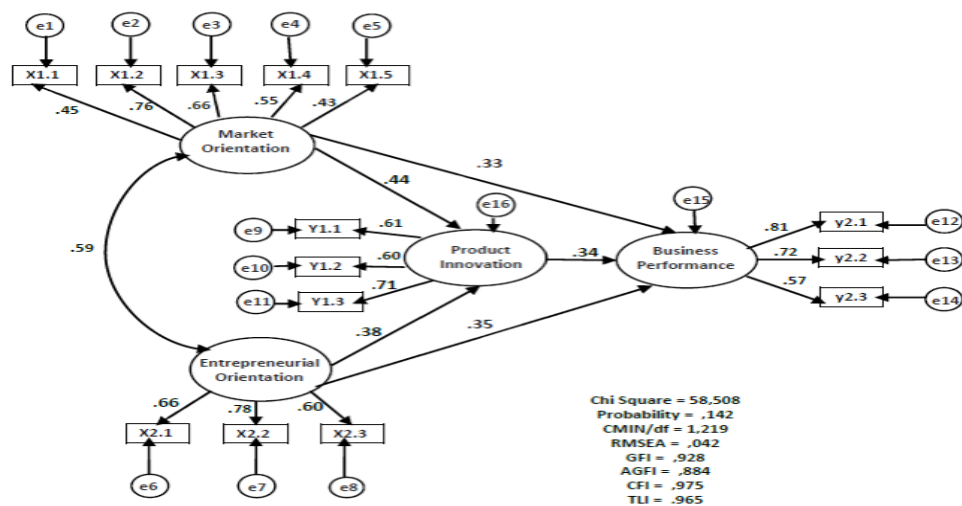


opinion of Hair, et al. (2006) which emphasized the use of more than one statistical match criteria (fit statistics) to assess the overall structural model fit. In addition, Hair, et al. (2006) states that there is no requirement that all goodness of fit indices must vary. Furthermore, the assessment of the overall structural fit model includes absolute fit performed using Chi-Square, Root Mean Square Error of Approximation (RMSEA) and Goodness of Fit Index (GFI), as well as Fit Incremental size with the Adjusted Goodness of Fit Index (AGFI) and Tucker-Lewis Index (TLI). The results of the structural model assessment in this study based on the Goodness of Fit Index criteria are presented in **Table 3** below:

**Table 3.** Goodness of Fit Index Overall Model Test

<i>Goodness of Fit</i>	<i>Cut-off</i>	<b>Result (default model)</b>	<b>Description</b>
<i>Chi Square</i>	small	58,506	Good model
P-value	> 0,05	0,142	H0 supported
CMIN/df	≤ 2,00	1,219	Good model
RMSEA	≤ 0,08	0,042	Good model
GFI	≥ 0,90	0,928	Good model
AGFI	≥ 0,90	0,884	Good model
CFI	≥ 0,90	0,975	Good model
TLI	≥ 0,90	0,965	Good model

While the results of a complete SEM analysis (Full Model Structural Equation) are presented in **Figure 2**.



**Figure 2.** Full Model Structural Equation

The structural model test results shown in **Table 3** and **Figure 2** show that this model is acceptable, although not all of the model's goodness of fit criteria meet the requirements. Furthermore, the test results of the model are feasible to be presented because they are considered to have accurate estimation values. This means that theoretically a good estimate is if it produces small residuals. To see whether the estimation model has a satisfying predictive degree by looking at

the residual value, namely observing the standardized residual covariance matrix (Ferdinand, 2014). The residual value is set at  $\pm 2.58$  at a 1% significance level (Hair, et al., 2006). This information can be seen from the standardized residual covariance value shows that the residual value is in the range  $\pm 2.58$ . This shows that the predictive results of the structural model are accurate, so there is no need to modify the model.

**Table 4.** Result of Hypothesis Test (*Direct Effect* and *Indirect Effect*)

Independent Variable	Dependent Variable	Coeffisien Path <i>Direct Effect</i>			Coeffisien Path <i>Indirect Effect</i>			<i>Total Effect</i>
		Coef.	P-Value	Sig.	Mediator Variable	Coef.	Sig.	
Market Orientation	Business Performance	0,326	0,045	Sig.	Product innovation	0,152	Sig.	0,478
Market Orientation	Product innovation	0,440	0,019	Sig.	***	0,000	***	0,440
Entrepreneurial Orientation	Business Performance	0,348	0,015	Sig.	Product innovation	0,130	Sig.	0,478
Entrepreneurial Orientation	Product innovation	0,378	0,022	Sig.	***	0,000	***	0,378
Product innovation	Business Performance	0,345	0,044	Sig.	***	0,000	***	0,345

## HYPOTHESIS TESTING

### *Hypothesis 1*

Hypothesis 1 states that "market orientation has a positive effect on business performance." Based on **Table 4**, shows that the Standardized Regression Weight coefficient on the path of the relationship between market orientation and business performance is 0,326 with a probability (p-value) of 0.045 smaller than 0.05 (p-value > 0.05). These results show empirical evidence that market orientation has a positive and significant effect on business performance in the context of SMEs. That is, the higher the market orientation level of SMEs in the fashion creative industry, the higher the business performance obtained. This finding is consistent with the results of research conducted by Narver and Slater

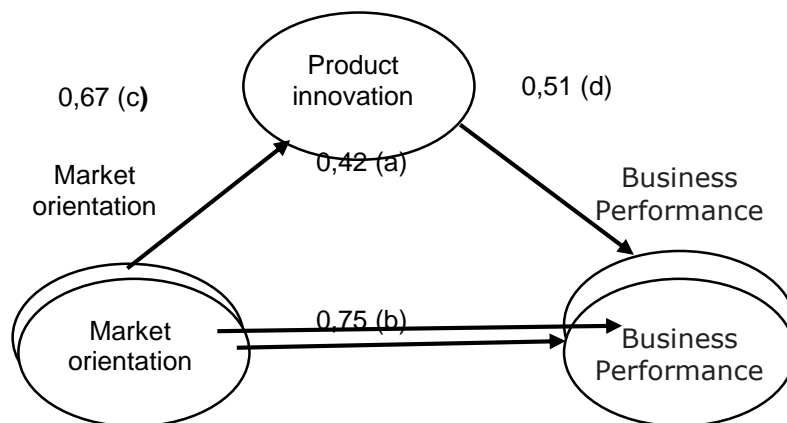
(1990); Kohli and Jawroski (1990); in line with the results of a meta-analysis conducted by Ellis (2006) about the relationship of market orientation with performance. In particular, these findings also support a literature study of sixteen studies conducted by Raju et al. (2011), which proves a positive (direct or indirect) relationship between market orientation and business performance in the context of SMEs.

**Hypothesis 2**

Hypothesis 2 states that "entrepreneurial orientation has a positive effect on business performance." Based on **Table 4**, shows that the Standardized Regression Weight coefficient on the path of the relationship between market orientation and business performance is 0,348 with a probability (p-value) of 0.015 smaller than 0.05 (p-value > 0.05). These results show empirical evidence that entrepreneurial orientation has a positive and significant effect on business performance in the context of SMEs. That is, the higher the level of entrepreneurial orientation of SMEs in the creative fashion industry, the higher the business performance obtained. The findings in this study are consistent with the conception of Miller (1983); Covin and Slevin (2006) that entrepreneurial orientation related to innovative behavior, proactive behavior and courage to take risks can improve business performance. The results of this study also support the research of Avlonitis and Salavou (2007) who found a positive and significant influence of entrepreneurial orientation on company performance.

**Hypothesis 3**

Hypothesis 3 states that "market orientation has a positive effect on business performance through product innovation." Mediation Test results show that Product Innovation (Y1) mediate indirect effects from the influence of Market Orientation (X1) on Business Performance (Y2). This can be seen from the coefficient value of the Standardized Regression Weight on the path of indirect relationship between Market Orientation and Business Performance of 0.152 with a probability (p-value) smaller than 0.05 (p-value < 0.05). This result gives meaning that understanding and implementation of Market Orientation as the basis for applying Product Innovation is able to improve Business Performance so that hypothesis 3 can be supported.

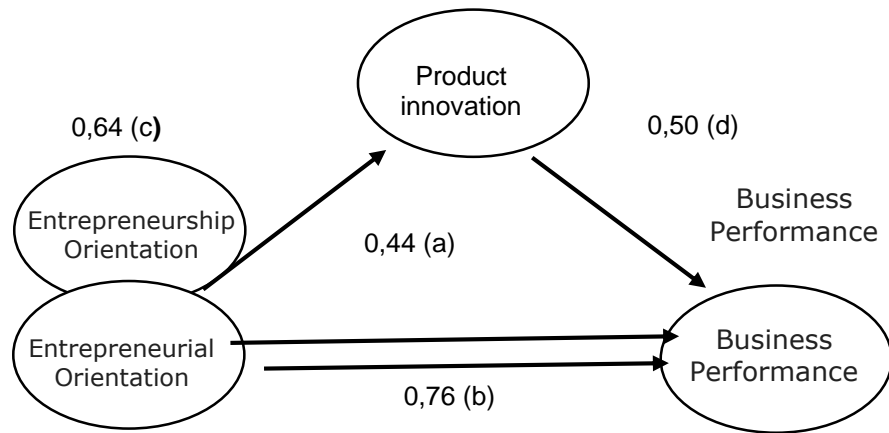


**Figure 3.** Mediation Test of Effect of Market Orientation on Business Performance mediated by Product Innovation

Based on the results of the mediation test (**Figure 3**), it can be seen that Market Orientation has an indirect impact on business performance through the Product Innovation variable. From the path of the relationship between Market Orientation and Product Innovation shows that the Market Orientation variable can significantly explain the Product Innovation variable with a coefficient of 0.670 (c). In addition, the Product Innovation variable is significantly able to explain the Business Performance variable with a coefficient of 0.510 (d). While the path coefficient of the Market Orientation variable that is controlled by the Product Innovation variable is able to significantly explain the Business Performance variable with a coefficient of 0.422 (a). Furthermore (a) has a smaller coefficient value (down) from the influence of Market Orientation on Business Performance without a product innovation variable (b). The coefficient value of (b) is 0.746. Thus, it can be said that Product Innovation acts as a partial mediation of the indirect effects of Market Orientation on Business Performance. The results of this test indicate that Market Orientation is able to improve Business Performance through Product Innovations that are carried out and then Product Innovation will be able to improve Business Performance. This finding is consistent with Han, Kim, and Srivastava (1998); Low et al. (2007) which proved a positive correlation between market orientation and innovation, and between innovation and company performance. This study also supports several findings that use innovation as a mediation of market-performance-business relationship in the context of SMEs (Laforet (2009); Raju et al. (2011); ability to introduce unique products and combinations of orientations market and product innovation contribute to superior performance in SMEs (Avlonitis and Salavou, 2002).

***Hypothesis 4***

Hypothesis 4 states that "Entrepreneurial Orientation has a positive effect on Business Performance through Product Innovation." Mediation Test results show that Product Innovation (Y1) mediate indirect effects from the influence of Entrepreneurial Orientation (X2) on Business Performance (Y2). This can be seen from the coefficient value of the Standardized Regression Weight on the path of the indirect relationship between Entrepreneurial Orientation and Business Performance of 0.130 with a probability (p-value) smaller than 0.05 (p-value <0.05). This result gives meaning that understanding and implementation of Entrepreneurial Orientation which is used as the basis for the application of Product Innovation can improve Business Performance so that hypothesis 4 can be supported.



**Figure 4.** Mediation Test of Effect of Entrepreneurship Orientation on Business Performance Mediated by Product Innovation

Based on the results of the mediation test (**Figure 4**), it can be seen that the entrepreneurial orientation has an indirect impact on business performance through the product innovation variable. From the path of the relationship between Entrepreneurial Orientation and Product Innovation shows that Entrepreneurial Orientation variable is significantly able to explain Product Innovation variable with a coefficient of 0.640 (c). In addition, Product Innovation variable is significantly able to explain Business Performance variable with a coefficient of 0.501 (d). While the path coefficient of the Entrepreneurial Orientation variable that is controlled by the Product Innovation variable is able to significantly explain Business Performance variable with a coefficient of 0.441 (a). Furthermore (a) has a smaller coefficient value (down) from the influence of Entrepreneurial Orientation on Business Performance without Product Innovation variable (b). The coefficient value of (b) is 0.756. Thus, it can be said that Product Innovation plays a role as a partial mediation of indirect effect of Entrepreneurial Orientation on Business Performance. The results of this test indicate that Entrepreneurial Orientation is able to improve Business Performance through Product Innovations carried out and furthermore Product Innovation will be able to improve Business Performance. This study supports the views of Rhee et al. (2010); Hult et al. (2004) that entrepreneurial orientation is an attitude towards specific types of behavior, while innovation is to build outcome-based behavior. From this point of view, entrepreneurial orientation can be considered as an antecedent of innovation, and shows that both are separate constructs.

**Hypothesis 5**

Hypothesis 5 states that "Product Innovation has a positive effect on Business Performance." Based on **Table 4**, shows that Standardized Regression Weight coefficient on the path of relationship between Product Innovation and Business Performance is 0.345 with a probability (p-value) of 0.044 smaller than 0.05 (p-value>0.05). These results show empirical evidence that Product Innovation has a positive and significant effect on Business Performance in the context of SMEs. That is, the higher level of SME Product Innovation in the creative fashion industry, the higher Business Performance obtained. From **Table 4**, the

total value of effect of the relationship between Market Orientation and Entrepreneurial Orientation through the mediation of Product Innovation has the same value (0.476). This indicates that the mediation of Product Innovation in generating the impact of the influence between Market Orientation and Entrepreneurial Orientation plays a very important role in creating better performance for SMEs. This finding is consistent with the study of Rosenbusch et al., (2011); Atuaheme-Gima and Ko (2001); Low et al. (2007) which shows that innovation has a positive effect on SME performance.

## CONCLUSIONS

This research focuses on three main issues; first, the relationship between market orientation, entrepreneurial orientation, and business performance. Second, the role of product innovation as a mediator variable. Third, the application of the relationship of market orientation, entrepreneurial orientation, product innovation and business performance in the context of SMEs. The results showed that market orientation and entrepreneurial orientation had a direct and indirect influence through the mediation of product innovations on business performance, especially in creative (fashion) SMEs in the province of DIY, Indonesia. This research provides empirical contributions to the market focused concepts of Narver and Slater (1990); the concept of entrepreneurship from Miller (1993); the concept of strategic configuration in a manufacturing company is where the company truly adapts to the environment through new product development innovations (Manu and Sriram (1996).

This research has several limitations; first, this study adopted the design of a cross-sectional study, so that the findings could not explain how the innovation development process took place in SMEs. Future research is recommended using longitudinal studies. Second, this study only examines the mediator's role of innovation, for future research, perhaps evaluating other contingency factors such as organizational structure, pressure on the business environment and business age as moderator variable. Third, this study cannot compare research models on various types of SMEs between the manufacturing and service sectors. Further research will be valuable if you can compare models of innovation in SMEs in the manufacturing sector and the service sector.

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