Journal of Management, Economic, and Financial

The Influence of Entrepreneurial Orientation on The Performance of Micro and Small Enterprises: The Mediating Role of Knowledge Management and Dynamic Capabilities

Imron Mashuri[1*], Wahdiyat Moko[2]
[1*,2] Department of Management, Universitas Brawijaya, Malang, Indonesia
*Emails: imronmashuri1@student.ub.ac.id

Abstract

This research discusses crucial aspects of Micro, Small, and Medium Enterprises (MSMEs) in Indonesia, focusing on comprehensive performance evaluation that includes financial and non-financial dimensions. Nevertheless, challenges such as the impact of the COVID-19 pandemic, limited entrepreneurial orientation, inadequate knowledge management, and difficulties adapting to rapid environmental changes have increased the rate of MSME closures in Indonesia. This study, involving 125 MSMEs in the Malang Raya region, examines the mediating role of knowledge management and dynamic capabilities in the relationship between entrepreneurial orientation and company performance. The results indicate that entrepreneurial orientation positively impacts company performance, knowledge management, and dynamic capabilities. However, knowledge management and dynamic capabilities do not significantly influence company performance, suggesting that they do not mediate between entrepreneurial orientation and company performance. Practically, these findings have significant implications for practitioners and policymakers seeking to enhance the performance of MSMEs in Indonesia. Recognizing the crucial role of entrepreneurial orientation in shaping positive company performance implies that fostering an entrepreneurial mindset is a key strategy. Nevertheless, considering the insignificant impact of knowledge management and dynamic capabilities on company performance, attention should be redirected towards alternative factors or strategies to address the unique challenges faced by Indonesian MSMEs. Policymakers can use these insights to design interventions targeting critical areas to create a conducive business environment for MSMEs in Indonesia.

Keywords

Firm Performance; Entrepreneurial Orientation, Knowledge Management, Dynamic Capabilities, MSMEs.

INTRODUCTION

For struggle with poor performance, including micro, small, and medium-sized enterprises (MSMEs)-financial aspects (Kotane & Kuzmina-Merlino, 2017). It is crucial for assessing organizational efficiency and effectiveness (Moko et al., 2021). Despite its significance, numerous businesses, including micro, small, and medium-sized enterprises (MSMEs), struggle with poor

performance. As many as 49.7% of businesses go bankrupt after their first five years (Shopify, 2022). This phenomenon is not exempted among micro, small, and medium enterprises (MSMEs), where an average of 50% to 60% are recorded to cease their operations within the first three years (Republika, 2019). The consequences of this could disrupt national economic stability.

In Indonesia, MSMEs play a pivotal role, contributing significantly to the economy's stability (Wu et al., 2017). According to data from the Ministry of Cooperatives and Small and Medium Enterprises of the Republic of Indonesia (2019), MSMEs account for a share of 99.99% of the total businesses in Indonesia. The dominant composition of MSMEs also has an impact on Indonesia's economy. MSMEs absorb 119,562,843 or 96.92% of the total workforce in Indonesia. Moreover, MSMEs also contribute to the Gross Domestic Product (GDP) with a share of 60.51%, equivalent to IDR 9.6 trillion, and integrate investments worth 60%. However, their contribution is still inadequate for substantial economic growth and income improvement (Bappenas, 2014). Challenges such as limited resources, innovation, access to capital, and adapting to changes hinder their development (Katadata, 2021).

The COVID-19 pandemic further exacerbated MSME challenges, impacting their performance. The results of the Bank Indonesia survey indicate that during the pandemic, 72.6% of MSMEs experienced a decline in performance due to the impact of COVID-19. A survey conducted by the Asian Development Bank (ADB) as of September 16, 2020, also revealed that 48.6% of Indonesian MSMEs closed as a result of the pandemic (FEB UB, 2020). Despite governmental efforts and various programs to support MSMEs, many have not optimally leveraged these initiatives.

Research on factors influencing MSMEs' performance is crucial. Entrepreneurial orientation, knowledge management, and dynamic capabilities stand as key factors. Entrepreneurial orientation emphasizes innovation, proactivity, and risk-taking, impacting business success (Lumpkin & Dess, 1996). Knowledge management enhances performance by facilitating learning, collaboration, and adaptation to market changes (Wee & Chua, 2013). Dynamic capabilities contribute to competitive advantage and better performance by identifying opportunities and responding to them (Teece et al., 1997).

Malang Raya holds a significant number of MSMEs in East Java, contributing substantially to the regional economy (DiskopUKM Jatim, 2019). However, MSMEs here face challenges in performance due to pandemic impact, low entrepreneurial orientation, inadequate knowledge management, and resistance to change.

Previous studies present mixed findings about the impact of entrepreneurial orientation on performance. Knowledge management and dynamic capabilities are proposed as mediators for the relationship between entrepreneurial orientation and performance.

Considering the complexities of MSMEs challenges and Malang Raya's importance, this study aims to address gaps in previous research, exploring the mediating role of knowledge management and dynamic capabilities in the relationship between entrepreneurial orientation and MSMEs performance. This research is focused on micro and small enterprises (MSEs) in Malang Raya. This is because the number of micro and small enterprises (MSEs) is highly dominant and they share similar characteristics. Furthermore, micro and small enterprises (MSEs) make a significant contribution to the economy. The study's insights can contribute to strategies for enhancing MSEs' growth and stability in the region and beyond.

Literature Review

Relationship between Entrepreneurial Orientation (EO) and Firm Performance (FP)

Micro and Small Enterprises (MSEs) with high entrepreneurial orientation, characterized by innovation, risk-taking, and proactivity, tend to have better performance (Covin & Lumpkin, 2011). Entrepreneurial orientation is a crucial resource for MSEs in making decisions that enhance firm performance (Lumpkin & Dess, 1996). It also helps MSEs meet customer needs and demands by introducing new products, modifying existing ones, and developing valuable ideas (Pulka et al., 2021). Studies show a significant relationship between entrepreneurial orientation and MSEs' performance (Ibarra-Cisneros & Hernandez-Perlines, 2020; Khan et al., 2020; Mahmood & Hanafi, 2013; Shah & Ahmad, 2019; Zhang & Zhang, 2012). Thus, MSEs led by entrepreneurs with a high orientation towards innovation, proactivity, and risk-taking tend to achieve better success and performance (Covin & Miles, 1999).

H1: MSEs led by entrepreneurs with a high entrepreneurial orientation tend to have better firm performance.

Relationship between Entrepreneurial Orientations (EO) on Knowledge Management (KM)

Entrepreneurial orientation plays a vital role in fostering creativity and innovation within organizations (Gupta & Moesel, 2007). Effective knowledge management requires individuals capable of risk-taking and creative thinking (Matin et al., 2013). Research demonstrates a significant relationship between entrepreneurial orientation and knowledge management. (Adam et al., 2022) suggest that entrepreneurial orientation positively influences knowledge management processes. High entrepreneurial orientation encourages employees to share skills and knowledge, aiding knowledge-building (Iqbal & Malik, 2019). MSEs led by entrepreneurs with high entrepreneurial orientation tend to have better knowledge management (Latif et al., 2021).

H2: MSEs led by entrepreneurs with a high entrepreneurial orientation tend to have better knowledge management.

Relationship between Entrepreneurial Orientation EO) on Dynamic Capabilities (DC)

According to (Lim & Kim, 2019), dynamic capabilities can be developed by gaining competitiveness driven by entrepreneurial orientation. Entrepreneurial orientation contributes to dynamic capabilities, enabling companies to sense opportunities, seize them, and adapt more effectively (Liu et al., 2021). Entrepreneurs with high entrepreneurial orientation pursue new opportunities that create value in uncertain environments (Alvarez & Barney, 2007). Research suggests a significant connection between entrepreneurial orientation and dynamic capabilities (Buttar & Koçak, 2011; Jantunen et al., 2005; Kurnia Fitriati et al., 2020).

H3: MSEs led by entrepreneurs with a high entrepreneurial orientation tend to have strong dynamic capabilities.

Relationship between Knowledge Management (KM) on Firm Performance (FP)

Effective knowledge management is crucial for maintaining competitive advantage and improving firm performance (Bakar et al., 2015). Studies demonstrate a positive relationship between knowledge management and MSE performance (Gharakhani & Mousakhani, 2012; Ha et al., 2021). The results of the study indicate that knowledge management, which consists of knowledge acquisition, knowledge sharing, and knowledge application, significantly positively influences MSEs' performance. Meanwhile, (Ha et al., 2021) suggested that knowledge management dimensions, including knowledge acquisition, knowledge conversion, and knowledge protection, are positively related to firm performance.

H4: MSEs led by entrepreneurs who implement good knowledge management tend to have better firm performance.

Relationship between Dynamic Capabilities (DC) on Firm Performance (FP)

The concept of dynamic capabilities is used to explain how companies utilize internal resources and capabilities to gain a competitive advantage in a dynamic business environment (Akenroye et al., 2020). According to (Teece et al., 1997), dynamic capabilities are defined as the ability to change and reconfigure internal and external resources through a series of behaviours. This enables companies to adapt to environmental changes quickly, achieve competitive advantages, gain profits, and enhance firm performance (Liu et al., 2021; Saebah et al., 2023). Prior research establishes a positive link between dynamic capabilities and firm performance. (Eisenhardt & Martin, 2000) argue that dynamic capabilities serve as a means to integrate, reconfigure, and release resources to align with market changes. (Nedzinskas et al., 2013) revealed that dynamic capabilities have a positive impact on the performance of SMEs. (Martins, 2022) also, dimensions of dynamic capabilities, including sensing, seizing, and transforming, positively influence SME performance.

H5: MSEs led by entrepreneurs with strong dynamic capabilities tend to have better firm performance.

The Relationship of Entrepreneurial Orientation (EO) to Firm Performance (FP) Through Knowledge Management (KM)

According to (Abu Bakar & Mamat, 2017), entrepreneurs must be innovative, proactive, and willing to take risks to sustain and enhance company growth. Additionally, entrepreneurs with a high entrepreneurial orientation can improve knowledge management within the company (Adam et al., 2022). Some studies indicate that knowledge management acts as a mediator in the relationship between entrepreneurial orientation and firm performance. (Adam et al., 2022) demonstrate that effective knowledge management implementation can enhance the relationship between entrepreneurial orientation and company performance. (Abu Bakar & Mamat, 2017), reveal that knowledge management plays a mediating role between entrepreneurial orientation and MSEs performance.

H6: MSEs led by entrepreneurs with both a high entrepreneurial orientation and good knowledge management tend to have better firm performance.

The Relationship of Entrepreneurial Orientation (EO) to Firm Performance (FP) Through Dynamic Capabilities (DC)

According to (Kurnia Fitriati et al., 2020), entrepreneurial orientation is a crucial factor that significantly influences the development of dynamic capabilities, which in turn helps enhance superior firm performance. This aligns with the research of (Buttar & Koçak, 2011), which revealed that entrepreneurial orientation has a positive impact on the development of dynamic capabilities, ultimately positively affecting firm performance. (Abu-Rumman et al., 2021) also disclosed that entrepreneurial orientation develops the dynamic capabilities needed to achieve high firm performance advantages.

H7: MSEs led by entrepreneurs with both a high entrepreneurial orientation and strong dynamic capabilities tend to have better firm performance.

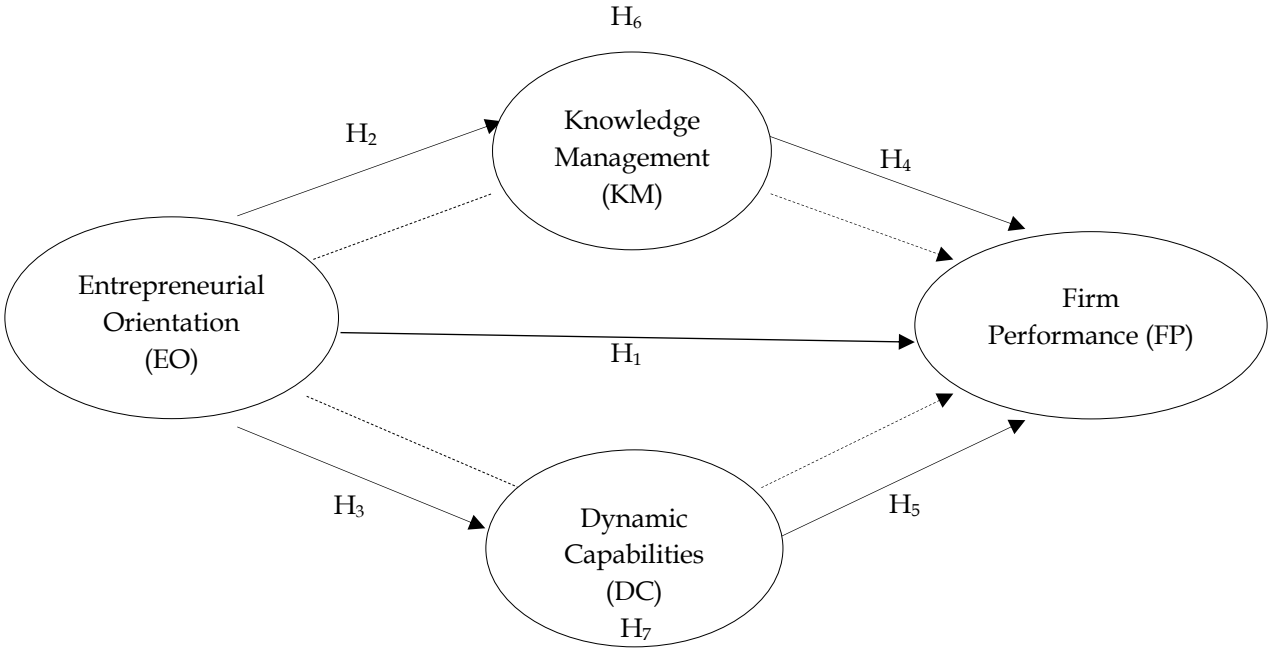

Figure 1. Conceptual Framework

METHOD

The approach used in this study is quantitative data analysis. This research was conducted by distributing questionnaires to owners of micro and small-sized enterprises (MSEs) located in Malang Raya. There are 125 owners were used as research samples. Questionnaires were distributed using Google Forms and directed to owners of micro and small-sized enterprises (MSEs).

The research questionnaire includes 25 items encompassing four sections entrepreneurial orientation, knowledge management, dynamic capabilities, and firm performance. The items were scored based on a five-point Likert scale from "completely disagree" to "completely agree" in the variables of entrepreneurial orientation, knowledge management, and dynamic capabilities. Firm performance variable, a Likert scale adopted from Gebauer et al. (2010) was used, with adjustments made to micro and small enterprises (SMEs) in the Malang Raya region, ranging from 1 (<2.5%), 2 (2.5%-5%), 3 (5%-7.5%), 4 (7.5%-10%), to 5 (>10%). All items were adapted from existing literature and based on validated scales including entrepreneurial orientation (Liu & Xi, 2021); knowledge management (Samir, 2020); dynamic capabilities (Lopez-Cabrales et al., 2017); and firm performance (Munizu, 2010). The statistical procedures and measures were reliability and validity analysis and structural equation modeling partial least square (SEM-PLS), and data were analyzed using the statistical software Smart PLS v3.

RESULT AND DISCUSSION

The validity of research items was assessed through Convergent Validity and Discriminant Validity tests to evaluate the loading factor. Indicators with loading factor values lower than 0.6 were considered invalid and were excluded from the research model. The indicators were considered valid if their outer loading values were above 0.6, as shown in Table 1.

Table 1. Outer Loading Value

Construct	Items	Outer Loading	Validation
Entrepreneurial Orientation	EO1	0.677	Valid
	EO2	0.695	Valid
	EO3	0.775	Valid
	EO4	0.695	Valid
	EO5	0.714	Valid
	EO6	0.795	Valid
Knowledge Management	KM1	0.619	Valid
	KM2	0.609	Valid
	KM3	0.822	Valid
	KM4	0.878	Valid
	KM5	0.798	Valid
	KM6	0.763	Valid
Dynamic Capabilities	DC1	0.703	Valid
	DC2	0.755	Valid
	DC3	0.782	Valid
	DC4	0.663	Valid
	DC5	0.760	Valid
	DC6	0.741	Valid
	DC7	0.778	Valid
Firm Performance	FP1	0.951	Valid
	FP2	0.972	Valid
	FP3	0.942	Valid

Furthermore, the research indicators were tested for reliability with Cronbach's Alpha value of > 0.6; Composite Reliability > 0.7; and AVE > 0.5. All items used to measure the variable have a value above the standard of reliability measurement. Thus, the research items are reliable for measuring research variables. The results of the reliability test are shown in Table 2:

Table 2. Construct Reliability

Construct	Composite Reliability	Cronbach's Alpha	Average Variance Extracted (AVE)
Entrepreneurial Orientation	0.870	0.821	0.528
Knowledge Management	0.886	0.845	0.570
Dynamic Capabilities	0.895	0.863	0.549
Firm Performance	0.969	0.952	0.912

Evaluation of the inner model can be seen from several indicators, including the coefficient of determination (R^2) and the Goodness of Fit Index (GoF) (Hussein, 2015). Based on the value of R^2, entrepreneurial orientation influences knowledge management by 0,456 (45,6%), while entrepreneurial orientation has an effect on dynamic capabilities by 0,591 (59,1%), and entrepreneurial orientation, knowledge management, and dynamic capabilities affect firm

performance by 0,098 (9,8%). GoF in this study was calculated using the equation $Q_2 = 1 – [(1-R_1^2) (1- R_2^2) [(1- R_3^2)] = 1 – [(1-0,456) (1-0,591) [(1-0,098)]= 0,799$. A score of 0,799 > 0 in the Q_2 calculation shows that the model in this study can be said to have a suitable and appropriate use.

Table 3. Path Coefficient

Hypothesis	Path	Path Coefficient	T Value	p-value	Result
H1	EO → FP	0.314	2.260	0.012	Significant
H2	EO → KM	0.676	12.980	0.000	Significant
H3	EO → DC	0.769	18.963	0.000	Significant
H4	KM → FP	-0.014	0.100	0.460	Not Significant
H5	DC → FP	0.011	0.072	0.471	Not Significant
H6	EO → KM→ FP	-0.009	0.097	0.462	Not Significant
H7	EO → DC→ FP	0.008	0.071	0.472	Not Significant

Table 3 shows hypothesis testing results. The testing results of the effect of entrepreneurial orientation (EO) on firm performance (FP) obtained a path coefficient of 0.314 with a T value of 2.260 and p-value of 0.012. Since T value > t-table 1.96 and p-value < alpha 0.05, it means that entrepreneurial orientation (EO) significantly influences firm performance (FP), therefore hypothesis H1 is accepted.

The testing results of the entrepreneurial orientation (EO) effect on knowledge management (KM) showed a path coefficient of 0.676 with a T value of 12.980 and a p-value of 0.000. Since T value > t-table 1.96 and p-value < alpha 0.05, it means that entrepreneurial orientation (EO) significantly influences knowledge management (KM), accordingly, hypothesis H2 is accepted

In a direct test between entrepreneurial orientations (EO) to dynamic capabilities (DC), the result shows a path coefficient of 0.769 with a T value of 18.963 and a p-value of 0.000. Since T value > t-table 1.96 and p-value < alpha 0.05, indicating a significant influence of entrepreneurial orientation (EO) on dynamic capabilities (DC), thus, hypothesis H3 is accepted.

The testing results of the knowledge management (KM) effect on firm performance (FP) showed a path coefficient of -0.014 with a T value of 0.100 and a p-value of 0.460. Since T value > t-table 1.96 and p-value < alpha 0.05, it means that knowledge management (KM) has not been proven to influence firm performance (FP), accordingly, hypothesis H4 is rejected

The results obtained from testing the influence of dynamic capabilities (DC) on firm performance (FP) indicated a path coefficient of 0.011. This coefficient was accompanied by a T value of 0.072 and a corresponding p-value of 0.471. Since T value > t-table 1.96 and p-value < alpha 0.05, it means that dynamic capabilities (DC) has not been proven to influence firm performance (FP), accordingly, hypothesis H5 is rejected.

The testing results of the knowledge management (KM) mediation effect on entrepreneurial orientation (EO) and firm performance (FP) relationship show a path coefficient of -0.009 with a T value of 0.097 and a p-value of 0.462. Since T value > t-table 1.96 and p-value < alpha 0.05. It means that knowledge management (KM) do not have a mediating effect on entrepreneurial orientation (EO) and firm performance (FP). Thus, hypothesis H6 is rejected

The testing results of the dynamic capabilities (DC) mediation effect on entrepreneurial orientation (EO) and firm performance (FP) relationship show a path coefficient of 0.008 with a T value of 0.071 and a p-value of 0.472. Since T value > t-table 1.96 and p-value < alpha 0.05. It is indicated that dynamic capabilities (DC) do not have a mediating effect on the relationship between entrepreneurial orientation (EO) and firm performance (FP). Consequently, the hypothesis H7 is rejected.

CONCLUSION

This study sheds light on the intricate interconnections among entrepreneurial orientation, knowledge management, dynamic capabilities, and firm performance within the micro and small enterprises (MSEs) context. The research reveals that a high entrepreneurial orientation significantly boosts firm performance, indicating that MSEs led by entrepreneurs with strong entrepreneurial orientations tend to excel overall. Additionally, entrepreneurial orientation is pivotal in driving effective knowledge management practices and fostering strong dynamic capabilities within MSEs. However, the study finds that neither knowledge management nor dynamic capabilities have proven direct impacts on improving firm performance in MSEs. Furthermore, the research indicates that knowledge management and dynamic capabilities do not mediate the relationship between entrepreneurial orientation and firm performance. This suggests that MSEs led by entrepreneurs with high entrepreneurial orientations can achieve superior performance without relying on these mediating factors. Despite the valuable insights gained, the study acknowledges certain limitations, such as reluctance among MSE owners to participate and the narrow focus on specific variables. Future research is recommended to explore additional influencing factors, consider non-financial performance indicators, and broaden the research population to enhance the understanding of MSE performance dynamics. These findings guide MSE leaders and policymakers seeking to make informed decisions to enhance the competitiveness and performance of micro and small enterprises.

Acknowledgment

The author would like to thank Radityo Putro Handrito, SE., MM., Ph.D for his contribution, support and valuable input in completing the paper.

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