

ENHANCING ORGANIZATIONAL PERFORMANCE OF MALAYSIAN SMEs THROUGH HUMAN RESOURCE MANAGEMENT (HRM) PRACTICES AND ORGANIZATIONAL INNOVATIVE CAPABILITY: A PROPOSED FRAMEWORK

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ABSTRACT

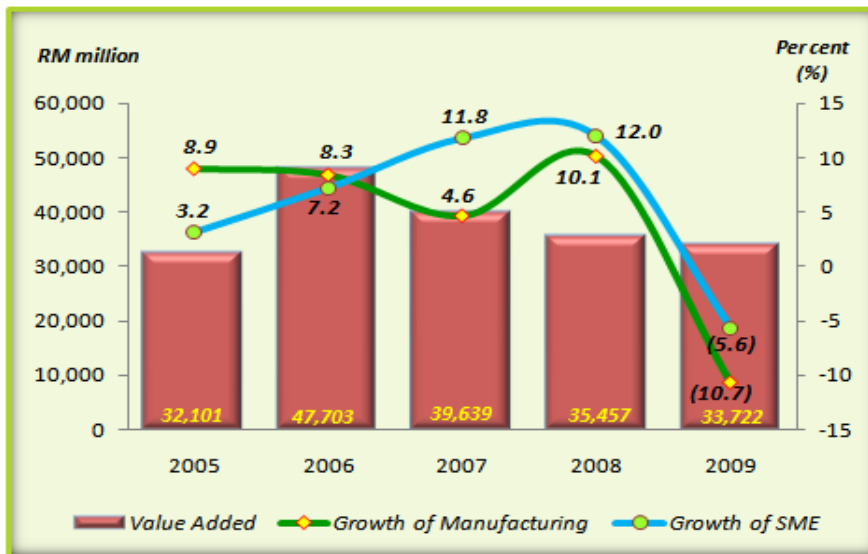
Generally, the literature says that SMEs play an important role in the development of the country to a superior level. However, the performance of Malaysian SMEs still has not reached the stage of full potential. To improve the performance, the SMEs need to realize their full potential and seize any opportunities to upgrade them to become more competitive. To remain competitive, SMEs have to shift towards higher value added activities, and adopt best industry business practices. Thus, SMEs need to change their mindset to transform themselves to support the strategies of Malaysia to become a high-income, developed country by 2020. This transformation requires SMEs to develop their organizational resources and capabilities that will move them to become more competitive, innovative, and with a technologically strong SME sector. Unfortunately, empirical studies on the impact of organizational resources and capabilities of SMEs to the issue of their performance, particularly in the Malaysian context have been less than encouraging. Given the importance of organizational resources, such as human resources (Abdullah, Ahsan, & Alam, 2009), and how they play a crucial role in the organizational operation and success, there is a need to investigate how the HRM helps the organization manage their employees in achieving higher performance and success. Apart from that, in order to be more effective, more successful, and keep on surviving (Damanpour & Schneider, 2006), SMEs should be actively involved in innovation. This is due to the capability of the organization to innovate mostly in promising positive implications for its performance (Pinho, 2008). Potentially, improved SMEs performance can be gained through HRM practices and organizational innovative capability. A survey to the SME manufacturing companies can show the relevance of HRM practices and organizational innovative capability towards improving performance. Therefore, empirical work in this relationship is needed to overcome this shortcoming.

Keywords: *Organizational Innovative Capability, Human Resource Management (HRM) Practices, Organizational Performance Practices and Small and Medium Enterprise (SME).*

1. Introduction

It has long been acknowledged that SMEs contribute significantly to overall economic performance in Malaysia. However, the performance of SMEs still has not reached the stage of full potential. Although the number of SMEs hit more than 90% of the total establishments in most countries, including Malaysia, it does not show the strength of a company or industry. In fact, SMEs have been very fragile and more vulnerable to the external environment (NSDC, 2012). This was proven during the current global economic and financial crisis and the 2011 catastrophe in Australia, Japan, New Zealand and the United States (US); Malaysian SMEs also indirectly suffered the impact of the crisis through trade channels of lower export demand and the slowdown in capital flows that affect investment. As declared in the report on the annual survey of manufacturing industries, 2010, following the downturn from the global economic and financial crisis in 2009, SMEs in the manufacturing sector registered a negative growth of 5.6%, which was in line with the overall performance of the manufacturing sector, which recorded a negative growth of 10.7%. The SME value added also showed a decrease of RM1, 735 million from RM 35,457 million in 2008 to RM 33, 722 million in 2009. This indicates that the decline of SMEs growth is very drastic, compared to four years back, where SMEs showed an increase in healthy growth in 2005 (3.2%), 2006 (7.2%), 2007 (11.8%), and 2008 (12%) as illustrated in Chart 1.1 below (DOSM, 2011).

Chart 1.1: Contribution of SMEs output and value added to the manufacturing sector, 2005-2009



Source: DOSM (2011)

In addition, the literature also found that the failure rate of SMEs is extremely high. Firms may fail at different stages. Some of the firms fail in their early stages while others fail after a few years of their establishment (Ladzani & Vuuren, 2002). For instance, a study by USA Small Business Administration noted that some 25% of small enterprises fail within two years, and 63% fail within six years. It was also reported that this similar rate of failure occurred in the UK, the Netherlands, Ireland, Japan, and Hong Kong. Meanwhile, Shepherd and Wiklund (2009) also disclosed that almost 50% of new firms survive up to six years and then die off. Similarly, in Malaysia, a report from Portal Komuniti KTAK, 2006, has

revealed that the failure rate among SMEs was as high as 60% (N. H. Ahmad & Seet, 2009), and this figure is considered quite alarming (Jamaludin & Hasun, 2007).

Among the reasons that most SMEs did not survive in the industry was due to the lack of competitiveness, especially during the economic crisis. This was proven during the economic crisis in 2009; it was found that many SMEs were unable to survive. On the other hand, when the economy recovered in 2010, SMEs recorded the highest growth rate in the manufacturing sector by 11.4%, followed by the service sector (6.8%), construction (5.1%) and agriculture (2.1%) (NSDC, 2011). This improved performance of SMEs in the manufacturing sector was due to the various government stimulus programs under the Economic Transformation Program (ETP) that provide a spillover effect on suppliers thereby benefit SMEs in the manufacturing sector (NSDC, 2011). Thus, it indicates that the SMEs suffered from lack of preparedness, are yet to be considered independent, and still rely on government support to cope with any possibility contingencies in the future. As a result, it is crucial to investigate the reasons behind the high failure rate and low performance among Malaysian SMEs.

To improve the performance, the SMEs need to realize their full potential and seize any opportunities to upgrade them to become more competitive. To remain competitive, SMEs have to shift towards higher value added activities, and adopt best industry business practices that will help them to prepare and recover from natural disasters, where SMEs are particularly vulnerable. This is in line with the theme of "*Transformation to the New Economic Model*", which has enormous implications for SMEs (NSDC, 2010). SMEs need to change their mindset to transform themselves to support the Malaysian strategies to become a high-income, developed country by 2020. This transformation requires SMEs to develop their organizational resources and capabilities that will move them to become more competitive, innovative, and with a technologically strong SME sector. These organizational resources and capabilities are more devoted to realize high performance and high value-added SMEs, which are equipped with strong technical and innovation capabilities as well as personal and business skills to comprehend new job opportunities, and better market access. Unfortunately, empirical studies on the impact of organizational resources and capabilities of SMEs to the issue of their performance, particularly in the Malaysian context have been less than encouraging. Therefore, empirical work is needed to overcome this shortcoming.

Over the past decade, the literature clearly shows that HRM practices influence organizational performance, but very little is known about what goes on in the "black box" between HRM practices and performance. That is, the lack of precision studies of how HRM practices produce value to the organization. This indicates a vital message from the previous findings, that by purely investigating the direct relationship between HRM practices and performance, would reveal a partial overview of performance (Theriou & Chatzoglou, 2008; Wiklund & Shepherd, 2005). To date, there is very little research that explains the processes through which HRM practices (Becker, Huselid, Pickus, & Spratt, 1997) impact the primary intermediate variables that ultimately influence the performance of an organization. Thus, this paper investigates the relationship between HRM practices and organizational performance, and the influence of organizational innovative capability on organizational performance. Generally, the aim of this paper is to rectify this gap by developing a framework that provides a better understanding of how human resource management (HRM) practices influence the success or failure in the development of Malaysian SMEs. Specifically, to explore the degree to which the relationship between HRM practices and organizational performance is mediated by organizational innovative

capability. In order to meet this objective, the next section will explain the relationship between the HRM practices, organizational innovative capability and organizational performance. Then, this paper will discuss the role of organizational innovative capability as a mediator between HRM Practices and organizational performance of SMEs. Finally, this paper will end up with the proposed framework and conclusion.

2. Literature Review

2.1 HRM Practices and Organizational Performance

Human resources are strategic resources that are important to the organization as knowledge, skills, abilities, behaviors and interaction of the employees who have the potential to influence the performance of the organization (Osman, Ho, & Galang, 2011a). Unfortunately, in Malaysian SMEs, labor productivity (as measured by real value added per employee) is significantly lower than the large companies. In 2011, the average SME productivity is estimated at RM50, 498 per employees compared to the average productivity of large firms of RM 140, 691 per employee. This is attributed largely to the sizeable employment of unskilled employees by SMEs particularly in the labor-intensive industries across all economic sectors (NSDC, 2012). Therefore, to ensure the success of SMEs, SMEs need to retrain and upgrade skills of their employees to enhance the competitiveness and productivity. This is supported by Shahrman and Ling (2011, 23 June), who stated that for Malaysia to be a high-income nation, it is crucial to develop human capital capabilities. In brief, wiser employees make the organization better. However, to develop such employees, SMEs have to implement an appropriate strategy of human resource management (HRM).

Unfortunately, most HRM theories and literature have been focused on HRM studies in large organizations, and overlooked small organizations (Becker & Huselid, 1998; Huselid, 1995; Jackson & Schuler, 1995; Lado & Wilson, 1994). Similarly, the study of HRM-performance links in Malaysia also focused on large organizations (e.g. Daud, 2006; Hemdi, 2005; Osman, Ho, & Galang, 2011b; A. E. A. Othman, 2009; R. Othman, Abdul-Ghani, & Arshad, 2001; Rowley & Abdul-Rahman, 2007). Indeed, Subramaniam, Shamsudin, and Ibrahim (2011) argued that the question of the extent of HRM theories being applicable to SMEs is yet unclear, and the previous studies also revealed that the utilization and adoptions of the HRM practices in Malaysia SMEs are still limited (Daud & Mohamad, 2010; Hassan, 2010). Nonetheless, there are local studies that have been conducted in the context of SMEs, but do not focus on the effect of HRM practices on performance (e.g. Chelliah, Sulaiman, & Yusoff, 2010; Farinda, Kamarulzaman, Abdullah, & Ahmad, 2009; Hashim & Zakaria, 2010; Hilmi & Ramayah, 2008; Jajri & Ismail, 2009; Radam, Abu, & Abdullah, 2008). This is because, as claimed by Tansky and Heneman (2003), SMEs have been considered as second-class citizens by HRM researchers for too long. Thus, it is necessary to undertake HRM studies in SMEs so that the findings of these studies could provide more information in order to strengthen the theories in HRM, which include all conditions such as organizational size and structure (Heneman, Tansky, & Camp, 2000). Therefore, in turn, these are calls for a shift to focus towards HRM practices in SMEs, since there is limited understanding of the significant roles of HRM in small and emerging firms (Cardon & Stevens, 2004).

In view of the fact that HRM appears as an essential role for all businesses, more researches into this topic are called for, and as SMEs are not a 'scaled-down' version of large firms (Nguyen & Bryant, 2004),

all the findings related to HRM in large firms cannot be generalized to SMEs, since SMEs have their unique characteristics, such as the style of entrepreneurial management, flexibility, informal practices, and competitive strategies (Kwang, Songan, & Kian, 2008), as well as they also face different challenges, and demands of firm growth in competitive markets (Barrett & Mayson, 2006). Hence, Malaysian SMEs have to realize their own competencies, particularly their human resources and HRM practices, in order to transform SMEs into a more competitive and high-value creation industry (Ngah & Ibrahim, 2009). Subsequently, the practices of effective human resource management should be of concern to SMEs to assist in improving the performance within the organization. Moreover, they also need to figure out, value, and adopt the best practices of human resource management in order to ensure enhancement of sustainable performance.

There are several approaches in studying HRM practices in relation to organizational performance: universalistic, contingency or configurational approach (Delery & Doty, 1996; Youndt, Snell, Dean Jr, & Lepak, 1996). The universal, or "best practices" perspective is the simplest form of a theoretical model in HRM literature, and their researchers are micro analytical in nature. This perspective involves a direct relationship between HRM practices and performance (Youndt et al., 1996) whereby some HRM practices are hypothesized as constantly superior to others and these best practices should be adopted by all organizations (Delery & Doty, 1996). The contingency perspective, on the other hand, posits that the impact of HRM practices on firm performance is conditioned by an organization's strategic posture. Researchers in the contingency approach dispute that HRM practices that applied by any organization must be coherent with other aspects of the organization so as to be effective. They have tried to explain the interaction between various HRM practices and specific organization strategies as they relate to organizational performance (Youndt et al., 1996). In contrast to "best practice" and contingency approach, the configurational perspective is interested on how the pattern of multiple HRM practices is related to organizational performance. Wright & McMahan (1992) argued that there is the pattern of intended human resource deployments and activities that can facilitate organization in achieving their goals. In order to be effective, an organization must build up its HRM system that reaches both horizontal and vertical fit. Horizontal fit refers to the internal consistency of the organization's HRM practices, and vertical fit refers to the congruence of the HRM system with other organizational characteristics such as a firm strategy.

Consequently, in order to explain the process of examining HRM practices that are related to organizational performance, researchers can comply with either one of the approaches or a combination of the three different approaches. This conceptual paper adopts the universalistic perspective for several reasons. Firstly, the universalistic perspective is suggested as the primary approach since most of HR studies have centered on a holistic or universal view of HRM practices and organizational performance, highlighting set of practices used by all firm employees and the uniformity of these practices across firms. Secondly, this perspective enables researchers to study the contribution of each HRM practice on organizational performance relatively.

Drawing from universalistic or "best practices," there are several combinations of HRM best practices that have been studied in the context of SMEs, and yet no consistency has been achieved about which combination of practices is good or better than other combination. For example, Subramaniam et al. (2011) adapted four practices; Nasution et al. (2011) used two practices; Osman et al. (2011a) applied nine practices; Daud and Mohamad (2010) explored six practices; Kwang et al. (2008) adapted four

practices; Vlachos (2008) adapted six practices; Carlson et al. (2006) applied five practices and Cardon and Stevens (2004) analyzed six practices in their studies (see Table 2.1 for a summary of best HR practices used by different studies in SMEs).

Table 2.1: Summary of Best Practices in Human Resource used by different studies in SMEs

Subramaniam et al. (2011)	<ol style="list-style-type: none"> 1. Compensation policy 2. Information sharing 3. Training and development 4. Job security
Nasution et al. (2011)	<ol style="list-style-type: none"> 1. Job related 2. Reward related
Osman et al. (2011a)	<ol style="list-style-type: none"> 1. HR planning 2. Staffing 3. Job work design 4. Training & development 5. Performance appraisal 6. Compensation 7. Employee relations and communication 8. Health and safety 9. Job satisfaction
Daud and Mohamad (2010)	<ol style="list-style-type: none"> 1. Recruitment & selection 2. Training & development 3. Performance appraisal 4. Preparation of payroll 5. Communication with employees 6. Administrative management of HR
Kwang, et al. (2008)	<ol style="list-style-type: none"> 1. Selection and recruitment 2. Incentive and compensation 3. Training and development 4. Team-based problem-solving
Vlachos (2008)	<ol style="list-style-type: none"> 1. Compensation policy 2. Decentralization and self-managed teams 3. Information sharing 4. Selective hiring 5. Training and development 6. Job security
Carlson et al. (2006)	<ol style="list-style-type: none"> 1. Training and development 2. Recruitment package 3. Maintaining morale 4. Performance appraisals 5. Compensation
Cardon and Stevens (2004)	<ol style="list-style-type: none"> 1. Staffing 2. Compensation

	<ol style="list-style-type: none"> 3. Training & development 4. Performance management 5. Organizational change 6. Labor relations
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However, in this paper, the selection of HRM practices is based on the innovative HRM practices proposed by Agarwala (2003). Following Tan and Nasurdin (2010), this paper only adopted five Agarwala's innovative HRM practices, which are training and development, reward system, performance appraisal, staffing, as well as communication and information sharing. The practice of career management that was adapted by Tan and Nasurdin (2010) has been dropped since Tan and Nasurdin (2010) have discovered that career management did not have an effect on product, process and administration innovation. This is because the responding companies that mostly comprised of locally-owned companies were generally less aggressive in developing their employees' career paths compared to foreign-owned companies (Tan & Nasurdin, 2010; Chew, 2005). In fact, career management is not the most effective strategy for SMEs due to most employees who engaged in smaller companies are merely to obtain work experiences, so that they will be more prepared in coping with job opportunities at larger companies. They placed the SMEs as a stepping stone to further expand their career at larger organizations (C. Subramaniam et al., 2011). Thus, there is no sense of attachment for the employees towards their organization, and at the same time, employers are incapable of providing career management to employees due to financial constraints.

In addition, the selection of five HRM practices is based on Boselie, Dietz, and Boon (2005), who have compiled a list of research articles related to 'HRM and Performance'. In their review drawn on a comprehensive sample of 104 articles; the total of 83 articles is on the training and development, 71 articles on the contingent pay and reward scheme, 51 articles on the performance management (including appraisal), 50 articles on the recruitment and selection, 32 articles on communication and information sharing. These five basic practices listed have justified having the most support across various literatures. Lepak and Snell (2002), Snell and Dean (1992) and Youndt et al.(1996) similarly agree that the four key HRM practices are staffing, training and development, performance appraisal and compensation. While according to Pfeffer (1998), communicating and sharing of information is one of the seven practices of successful organizations and it is a key component in a high-performance work system (Zacharatos, 2001). Therefore, it is expected that these five HRM practices could influence organizational performance in the Malaysian SMEs.

After all, in the Malaysian context; SMEs do implement HRM practices, but only the basic practices of HRM. This is another reason to justify why only five basic HRM practices have been selected. This is proven with the emergence of recent studies on HRM practices in Malaysian SMEs. For example, Daud and Mohamad (2010) have investigated the extent to which HR practices are highlighted by the Malaysian SMEs. They discovered that there was a substantial difference between the 108 SMEs surveyed with respect to the adoption of HR practices, where a majority of these organizations used an informal approach to manage their HR practices. Meanwhile, the study by Osman et al. (2011a) in the service sectors, which have full-time employees not exceeding fifty, as defined by SME Corp. Malaysia, also disclosed that more than half of the 43 (51%) SMEs surveyed had an HR department in their

organization, while the remaining declared otherwise. They also revealed that SMEs with their own in-house HR department implement the HRM practices (such as training and development, performance appraisal, employee relations and communication) more often compared to SMEs without an in-house HR department. Besides that, employees show higher job satisfaction in the organizations that have their own HR department. In another recent study, Subramaniam et al. (2011) found that 84 SMEs (22 of them are small-sized) in the central region of Peninsular Malaysia demonstrated positive relationships between compensation, information sharing, and training and development to organizational performance. Moreover, there is one SME study done by Kwang et al. (2008), which examined the mediating role of HRM practices in the relationship between EO and organizational learning (OL) capability in Sarawak. They found that HRM practices directly and indirectly affect an SME's OL capability.

Therefore, within the context of this paper, and following Tan and Nasurdin (2010) and Agarwala (2003), HRM is conceptualized as combinations of several practices that are systematically designed to be geared towards improving SME effectiveness and yield better performance outcomes, in which comprises the practices of training and development, reward system, performance appraisal, staffing, as well as communication and information sharing. Among HR practices, training and development is of critical importance (Tanova & Nadiri, 2005). Carlson, Upton and Seaman (2006) observed that training and development is one of the most vital activities needed in an organization to succeed and survive. Stavrou-Costea (2005) suggested that every level of an organization should emphasize training and development practices, as the continuous training and development activities are possible to increase efficiency and flexibility of the employees in their work tasks. Previous research had found a positive relationship between training and development and firm performance (e.g., Huang, 2001; Loan-Clarke, Boocock, Smith, & Whittaker, 1999; Marshall, Alderman, Wong, & Thwaites, 1995; Mohamad, Lo, & La, 2009; Tzafir, 2006). In addition, Westhead and Storey (1996) discussed the importance of training practices in SME firms in enhancing performance. Even though they have critically argued the training requirements of needed and unneeded training activities for SME firms, the matters can be unconsidered as several recent studies have suggested that training and development might be differentiated between them, but the practices are still crucial to the organization's success and survival (Tanova & Nadiri, 2005). Although, it was recognized that training and development are important HRM issues in small firms, in terms of providing formal training, it is still being overlooked by them (Storey, 2002, 2004; Westhead & Storey, 1996). This is because most employers often underestimate the benefit and cost of training to small firms as not being worthwhile (Storey, 2004; Storey & Westhead, 1997). In Malaysia, several platforms of training are provided by the government to assist SME development in terms of managerial and technical training. Thus, given the importance of training and development in small firms, SMEs have to grab any opportunities and take the initiative to improve as well as update their employees' knowledge and skills in order to produce superior output.

In SMEs, the practice of reward system or compensation policy is believed to be a major influence on organizational performance. In their study, Carlson, Upton and Seaman (2006) found that compensation is one of the most critical practices of business performance. It can be a powerful message to the employees in seeking and maintaining certain required behaviors in organizations (Jassim, 2007). The behaviors indeed can enhance the organizational performance, as organizations will support the values and behaviors that are beneficial to the organization. Lo, Mohamad and La (2009) have found that incentives have a significant relationship on the organizational performance. They concluded that the

results had been expected, as the incentives are important remuneration that can practically increase the organizational performance. Similarly, Carlson, Upton, and Seaman (2006) found a positive significant impact of the use of competitive compensation for family-owned SME performance. They discovered that those firms that apply more cash incentive compensation are significantly related to sales growth performance at every level in the organization. In addition, Vlachos (2008) conducted a study on the effect of HRM practices on five different measures of firm performance, classified as firm-specific, market-related and overall firm performance. He discovered that the compensation policy has a significant effect on all performance variables, in which it improved the perceived product quality, perceived cost, perceived market share, perceived sales, and perceived overall performance.

Furthermore Mohamad, Lo and La (2009) found that the performance appraisal is correlated to achieve better organizational performance. Jassim (2007) mentioned that the performance evaluations are important and critical decisions as the managers or supervisors need to evaluate their employees' behaviors in order to achieve organizations' goals, which are the increase of performance and success. Indirectly, the performance management can encourage the employees to enhance their performance (Leede & Looise, 2005). The adoption of the performance appraisal will enable organizations and employees to review the past performance and set up planning and strategies to enhance the organizational performance in the future (Jassim, 2007).

In addition staffing is also a major influence on the organizational performance. Carlson et al. (2006) found that the recruitment, staffing or selection is one of the most important critical practices to business performance. Stavrou-Costea (2005) added that the appropriate selection employees enable organizations to flourish, produce greater productivity, quality and gain higher profitability. In spite of the recruitment or staffing practices are different between large and SME firms (Tanova & Nadiri, 2005) such as large organizations adopt more formalized recruitment compared to the SMEs, the practices' adoption remains crucial for both (Tanova, 2003). Ahmad and Schroeder (2002) also emphasized the importance of the recruitment practices as they believed that the improvement of performance and organizations' success is depended on the selection of the employees. They mentioned that the selection process is one of the basic principles of strategic management, and as a 'prevention is better than a cure' process.

Besides, previous empirical studies have also revealed the positive relationship between communication and information sharing and organizational performance. For instance, Morishima (1991) asserted that Japanese consultation committees disclosed that sharing of information has a positive correlation with the performance of an organization in terms of productivity and profitability, while a negative relation to labor costs. This is similar to Vlachos (2008), where he proved that information sharing improves market share and sales, but there is no significant relationship between information sharing and product quality or product cost. Information sharing can also affect organizational performance through synergistic working relationships that exist between employees (Nonaka, 1994 cited in Vlachos, 2008). Whenever employees exchange information and work together, they will establish a conducive organizational climate that encourages employees to give full commitment to the organization, and this could reduce the turnover rate among employees. Thus, synergistic working relationships and the decreased turnover rate will lead to the better performance of organizations (S. Ahmad & Schroeder, 2003; C. Subramaniam et al., 2011). Moreover, Subramaniam, Shamsudin and Ibrahim conducted a study in the context of Malaysian SMEs; they demonstrated that information sharing relates to organizational performance.

They discovered that SMEs facilitate their employees to share information, and trust will be developed among workers and employers, which enables SMEs to accumulate all the significant input in order to make decisions that are critical to organizational success. Hence, this conceptual paper proposes:

P1: HRM practices (training and development, reward system, performance appraisal, staffing and communication and information sharing) will have a positive relationship with organizational performance of SMEs.

2.2 HRM Practices and Organizational Innovative Capability

In a general sense, organizational innovation is normally described as “the adoption of a new idea or behavior by an organization” (Daft, 1978, p. 197). It refers to the process of generating, developing, and implementing ideas or behaviors that were new to the organization at the time of adoption (Damanpour, 1991; Damanpour & Evan, 1984; Damanpour & Gopalakrishnan, 1998). This definition is broad enough to encompass a variety of innovations related to all aspects throughout the organization, including a device, system, process, policy, procedure, program, product, or service. Thus, the innovation consists of new ideas or behavior development or implementation, whereby the innovation can be new products or services, new process technologies in manufacturing, a new structure or administrative system, or a new plan or program to connect organizational members (Damanpour, 1991). It is a process of changing an organization, whether it is in an internal or external environment, and aspires to contribute to the positive performance of the adopting organization (Damanpour, 1991). Moreover, the adoption of innovations in an organization can be a predictor of the performance of the organization (Calantone, Cavusgil, & Zhao, 2002), including SMEs (Heunks, 1998; Pinho, 2008), although sometimes the SMEs cannot be actively involved in the innovations due to the lack of expertise and financial problems (Ngah & Ibrahim, 2009).

In fact, innovation is a broad field of studies (Damanpour, 1991), and the phenomenon of innovation in organizations certainly has different interpretations within the different threads of the literature. Despite there being discrepancies between the concepts of innovation, innovativeness, the capacity to innovate, and innovative capability, overlapping of these concepts might exist (Damanpour, 1991). For example, Hurt, Joseph, and Cook (1977) conceptualized firm innovativeness from two viewpoints; first, as a behavioral variable, i.e., the rate of a firm’s innovation adoption, and second, as an organization’s willingness to change. Hurley and Hult (1998, p. 44) introduced two constructs of innovation, which are innovativeness as meaning “openness to new ideas as an aspect of a firm’s culture” and the capacity to innovate as “the ability of the organization to adopt or implement new ideas, processes, or products successfully”. This is in line with Tajeddini, Trueman, and Larsen (2006, p. 533), who incorporate the approach of Hurley and Hult (1998) and observed that innovativeness was “the willingness and ability to adopt, imitate, or implement new technologies, processes and ideas, and commercialize them in order to offer new, unique products and services before most competitors”.

Further, Avlonitis, Kouremenos, and Tzokas (1994) referred to organizational innovativeness as representing the latent capability to develop and implement new ideas, which consist of two crucial areas of technology and behavior. Wang and Ahmad (2004, p. 304) defined organizational innovativeness as “an organization’s overall innovative capability of introducing new products to the market, or opening up new markets, through combining strategic orientation with innovative behavior and processes.” Similarly, Nasution and Mavondo (2008, p. 484) posited that innovativeness as an

organizational capability was in “generating new ideas, and their incorporation into new products, processes, and administrative procedures in order to deliver superior customer value relative to competitors”.

Based on the above previous studies, organizational innovativeness can be viewed as organizational capabilities to innovate that are reflected through the characteristics and activities of innovativeness at the organizational level. According to Liao, Fei and Chen (2007, p. 348) innovation capability is defined as “the performance of the enterprise going through various types of innovation, and achieving an overall improvement of its innovation capability”, which include product innovation, process innovation, and personal innovation. Wang, Yen, Tsai, and Lin (2008) and Subramaniam and Youndt (2005) further conceptualized innovative capability as two major types, namely, incremental innovative capability and radical innovative capability. Whilst Akman and Yilmaz (2008) and Neely et al. (2001) defined innovative capability as the organization’s ability to generate innovative output, which is characterized by the innovative culture in an organization, the ability of internal processes, and the ability to understand and respond to the environment.

Based on the definition of innovative capability in the previous literature, organizational capabilities are important to provide and sustain competitive advantage, and to implement the entire strategy within the firm (Akman & Yilmaz, 2008), whereas innovative capability is a firm’s unique asset (Guan & Ma, 2003), a key success factor of industrial firms (Hult, Hurley, & Knight, 2004), and can be considered as a firm’s potential to produce innovative outputs (Neely et al., 2001). Therefore, following Akman and Yilmaz (2008) and Neely et al. (2001), this paper conceptualizes organizational innovative capability as the extent to which the owners/managers of SMEs perceive the organization’s ability to generate, develop and implement new ideas. These innovative capabilities comprise key characteristics, such as the culture of the firm, the internal processes adopted, and the capability to understand the attributes and trends of the external environment. According to Neely et al. (2001), the study conducted by UK’s CBI (Confederation of British Industry, 1995) and DTI (Department of Trade and Industry) discovered that innovative firms usually have a strong culture, whereby they have a clear mission and objective for the organization. The culture within the firm reflects a main organizational orientation towards innovation. All strategies in the firm will also be communicated clearly to their members, and their business orientations are based on continuous improvement, which is urged by total customer satisfaction and total quality management. Moreover, the style of working in highly innovative organizations is described to be more open, multi-functional, and team-working. The top management, on the other hand, always empowered employees to carry out their tasks at all levels and personally supports and commits the organization to innovate.

Related to the internal processes, innovative organizations will always be generating and capturing new ideas and behaviors. Knowledge will be shared and coordinated rapidly among employees. They also encourage employees to innovate by providing comprehensive employment schemes where successful ideas will be rewarded, while failure is considered as essential in the process of learning. In terms of understanding the external environment, innovative organizations must be able to react to the external environment by looking at customers and suppliers as an impetus to ideas. Relationships with R&D, design, sales, marketing, and customers should regularly be established as well. These firms also acknowledge the pivotal role of investors and government in the process of innovation, in which the

investor provides financial support, while the government provides particular standards to be followed by firms.

The importance of SMEs to the country is undeniable, especially their role in becoming competitive and in sustaining economic development. Therefore, the power of such technology, competitiveness, and the potential of innovation in SMEs must be increased, as well as their contributions to the economy, and their effectiveness has to be improved. For that reason, in SMEs, innovative capability is viewed as essential in achieving dynamic competitive advantage so that they can survive in today's rapidly changing economic environment (Romijn & Albaladejo, 2002). With this innovative capability, SMEs are able to select, develop, work, sustain, modify, enhance, and expand technologies and products. Hence, organizational innovative capability is an absolute requirement for Malaysian SMEs (Akman & Yilmaz, 2008).

Basically, the role of HRM can be utilized for predicting the innovations behavior in an organization (Damanpour & Gopalakrishnan, 1998). The effective management of a firm's human resources can promote enormous innovations from the employees by encouraging the behavior of 'creation and execution of knowledge' (Shipton, Fay, West, Patterson, & Birdi, 2005). Jiménez-Jiménez and Sanz-Valle (2005) and Shipton et al. (2005) also agreed that HRM practices are the crucial input for innovation, and the most powerful in motivating employees to increase and enhance their innovative behaviour (Ar & Baki, 2011; Tan & Nasurdin, 2010). Nasution et al. (2010) stressed that the HRM practices are critical in the development of innovation, as well as in the customer value, particularly in service innovations. Additionally, through effective HRM practices, employees will also be encouraged to experiment with new ideas, develop knowledge and implement changes in the organizations, whereby all of it contributes to innovation in the organization (Tan & Nasurdin, 2010). These suggestions are in line with proposals by Conway and McMackin (1997) and Smith et al. (2010), who stated that to be innovative, organizations should have participative and effective HRM practices, which later encourages new ideas and innovations.

In evaluating 220 businesses, Mavondo et al. (2005) found that HR practices are the major mechanism that affects organizational performance. This study suggests that HR practices and innovation are important mediators, and any related study of learning orientation, marketing orientation, or others should include the practices to enhance the performance. Lau and Ngo (2004) found that HR practices are significant to performance, as was evaluated using 332 firms in Hong Kong. It indicates that the HR practices were positively correlated to the evaluated innovation, which was in product innovation. In searching for the relationship between HR practices and innovation by interviewing 48 selected firms out of 220 SMEs that had been identified in Malaysia, Hashim et al. (2005) also indicated a significant positive correlation between HR practices and innovation activities in SMEs. They concluded that SMEs should strive to adopt the eleven HR practices (rewarded for innovation, creativity and innovation training, skills sharing, see people as people, develop innovation capabilities, recruit competent employees, various recruiting sources, various hiring procedures, continuous training and high job security) that were evaluated, as the practices can accelerate the innovation processes, which then leads to the organization's success and survival.

In fact, there is a large volume of published studies describing the role of HRM practices as the antecedents of innovative capability, whether in SMEs or large businesses. Some of the factors or

variables that have been measured in the HRM practices for both businesses include; career development (Sels et al., 2006), recruitment or selection or staffing (Osman et al., 2011b; Rahim, 2009), training and development (Zheng, O'Neill, & Morrison, 2009), performance management or appraisal (Hui, 2009), HR planning or function or department (Nguyen & Bryant, 2004), employee participation (Kok & Hartog, 2006), employee relations or communications (Cunningham & Rowley, 2007), compensation or reward system (Kwang et al., 2008), and others. However, considering that training and development, reward system, performance appraisal, staffing and communication and information sharing practices are the most commonly accepted in SMEs, this study will focus on those five HR practices in investigating their effects on the capability of an organization to innovate.

Training and development have been considered in preparing multivalent employees, which is related to the development of skills and knowledge needed for innovation activities (Jimenez-Jimenez & Sanz-Valle, 2008). Training is also associated with enhanced performance of organizations, as the training simplifies the development of the skills and knowledge needed for the organization (Shipton, West, Dawson, Birdi, & Patterson, 2006). At least, they must have the basic skills to perform their tasks effectively. The training also facilitates and advances the capabilities of accepting new knowledge and skills, which can be used to improve innovation competencies among the employees (Li, Zhao, & Liu, 2006). Shipton et al. (2006) shows that exploratory learning is highly related with organizations that handle training, whereby the exploratory learning will be higher compared to the non-training organizations. The exploratory learning, as well as skill development, is a potent way to encourage innovations in an organization.

The reward system or compensation also prominent in enhancing employees' motivation to be innovative (Chen & Huang, 2009). It is a prominent role of stimulating the innovation processes (Kok & Hartog, 2006). Leede and Looise (2005) in their study mention that an appropriate compensation or reward system may have a great impact to peoples, and the unbalanced approach in utilizing the reward system might lead to the negative effects to the organizations. In the organizations where innovation is the driving force, the reward system can motivate the employees to risk-taking, develop more products and generate newer ideas (Gupta & Singhal, 1993). The reward system can be both intrinsic and extrinsic rewards (Chen & Huang, 2009), such as freedom of creativity, financial rewards, promotions and other recognitions (Gupta & Singhal, 1993).

The performance appraisal or management is related to the supports or encouragements provided by organizations for the employees to work effectively (Leede & Looise, 2005), and it is likely to be in positive correlations with the organizational innovation (Shipton et al., 2006). It can elevate employees' motivation to embark on the innovation activities which promise favorable innovation results to the organizations (Jiménez-Jiménez & Sanz-Valle, 2005). For example, the diversity of innovations leads to be numerous of patents, publications, grants and reports, which portray the creativity and innovation processes and can improve an organization's performance (Gupta & Singhal, 1993). Kaufmann and Tödtling (2002) also argued the direct support schemes should be provided to high-risk decisions such as in the terms of funding and commercialization.

Staffing is a key practice for innovation (Jimenez-Jimenez & Sanz-Valle, 2008). This practice is related to the selection of peoples or employees based on their multivalent skills and appropriate to the organizational cultures (Chen & Huang, 2009). In a rationale, the selection of the employees promises confidently to the future organizations' success and survival (Jimenez-Jimenez & Sanz-Valle, 2008). Chen

and Huang (2009) stated that in order to innovate, an organization will probably face with the uncertainty of success; and of that problem, the organization will need employees who are risk-taking, flexible and tolerant of the uncertainty; and the characteristics of employees can be evaluated in the recruitment / selection / staffing actions. Through the effective recruitment / selection / staffing actions, employees will be the assets of producing new ideas in an organization's innovation process (Chen & Huang, 2009; Jimenez-Jimenez & Sanz-Valle, 2008).

Despite the extensive identification of the significance of HRM for innovation, the practices of communication and information sharing among employees will foster synergistic working relationships (Nonaka, 1994 cited in Vlachos, 2008), in which they will establish a conducive organizational climate that encourages employees to give full commitment and collaboration to the organization. Employees will become more creative and flexible where it will generate a variety of ideas and cause innovative behavior in the organization (Ar & Baki, 2011; Brockbank, 1999). It can be concluded that information sharing can develop competitive advantages for an organization. This competitive advantage can stimulate an organization through their technology or management abilities in order to enhance innovative activities in the organization (Liao et al., 2007). As a rationale, information sharing promises confidence for the future organization's success and survival. Hence, the following proposition is:

P2: HRM practices (training and development, reward system, performance appraisal, staffing and communication and information sharing) will have a positive relationship with organizational innovative capability.

2.3 Organizational Innovative Capability and Organizational Performance

Organizational innovative capability demonstrates a strong influence on the organizational performance (Kitapci, Aydin, & Celik, 2012; Lee & Hsieh, 2010; McDermott & Prajogo, 2012; Rosenbusch, Brinckmann, & Bausch, 2011). The capability of an organization to innovate allows a diversity of strategies and opportunities to be pursued in order to enhance growth and survival. An organization that emphasizes innovation activities will have a higher impact on their employees' sense of commitment and productivity in terms of higher job satisfaction, lower employee turnover, and subsequently, to boost organizational productivity (Rosenbusch et al., 2011; Zhou, Gao, Yang, & Zhou, 2005). Therefore, the organization's ability to innovate can be an effective strategic capability for SMEs to address problems related to the smallness and newness. In sum, the literature recommends that SMEs that cultivate innovation have a more positive impact upon the performance of an organization than mainly focusing on the creation of innovative products and services (Rosenbusch et al., 2011).

Furthermore, some analysts (e.g. Avlonitis & Salavou, 2007; Calantone et al., 2002; Hult et al., 2004; Keskin, 2006; Rhee, Park, & Lee, 2010) have attempted to draw similarities in the relationship between innovation and organizational performance. For instance, these authors argue that organizational innovativeness is strategies and actions that can be undertaken within the organization in order to realize corporate orientations and goals, where it has been proved to be among the most powerful contributors to business performance. They further argued that firms will be more successful in responding to their environment, if they have greater capacity to innovate. This enables SMEs to develop new capabilities that can lead to competitive advantage and ultimately, achieve superior performance. Meanwhile, Luk et al. (2008) investigated organizational innovativeness in two types of administrative innovativeness and product-related innovativeness in relation to business performance in

the transition economy of China. They found that both types of organizational innovativeness are drivers of business performance.

Additionally, Akman and Yilmaz (2008), in their study, highlight that the success of innovation is most influenced by innovative capability, and this indicates that innovative capabilities are significant to SME success (Hoq & Ha, 2009). In assisting innovation success, innovative capability develops the interaction between customers and the environment associated with products to be developed. Meanwhile, the internal and external factors concerned with innovative capability are significantly related to innovation performance (Romijn & Albaladejo, 2002). This finding is also supported by Lee and Hsieh (2010), who proposed that an enterprise needed to focus on the entrepreneurship organization culture and innovative capability in order to sustain its competitive advantage. Therefore, it is a must for SMEs in Malaysia to develop their innovative capability with the aim of organizational performance improvement. Accordingly, this suggests:

P3: Organizational innovative capability will have a positive relationship with organizational performance of SMEs.

2.4 The Mediating Role of Organizational Innovative Capability

The researcher has found that most of the previous studies focus on the direct relationship of HRM and organizational performance (Bae & Lawler, 2000; Guest, 1997; R. Othman et al., 2001). They have also revealed that HRM practices have a consistent relationship, and significantly influence organizational performance (e.g. Abdullah, Ahsan, & Alam, 2009; Carlson et al., 2006; Hassan, 2010; Omar, Arokiasamy, & Ismail, 2009; Panayotopoulou, Bourantas, & Papalexandris, 2003; Richard & Johnson, 2001). This consistent relationship between HRM practices and organizational performance has driven further research to be conducted in order to identify the mechanism through which these relationships exist. Hence, organizational innovative capability has been introduced as their mediator. Furthermore, researchers in organizational theory have agreed that organizational innovative capability positively impacts organizational performance. Nonetheless, the predictors of innovative capability, and how those predictors influence organizational performance through innovative capability, have not been clearly investigated, particularly in the context of SMEs (Lin, Peng, & Kao, 2008).

Previous studies have shown that innovative capability acts as a strong intermediate indicator of the success of an organization. According to Keizer, Dijkstra, and Halman (2002), innovation is among the primary processes by which SMEs can contribute to the increase in the economic dynamism of each industry. Therefore, SMEs should have the capability to innovate in order to enhance their organizational performance. Indeed, in conducting research related to organizational innovative capability or organizational innovativeness, several researchers have examined several predictors to innovative capability, which in turn, lead to organizational performance. For instance, market orientation (e.g. Hoq & Ha, 2009; Hult et al., 2004; Jimé'nez-Jimenez, Valle, & Hernandez-Espallardo, 2008; Keskin, 2006; Rhee et al., 2010), learning orientation (e.g. Calantone et al., 2002; Hult et al., 2004; Jimé'nez-Jimenez et al., 2008; Keskin, 2006; Kitapci et al., 2012; Tajeddini, 2009); entrepreneurial

orientation (e.g. Hoq & Ha, 2009; Hult et al., 2004; Lee & Hsieh, 2010; Nasution et al., 2011; Rhee et al., 2010), social capital orientation (e.g. Hoq & Ha, 2009; Luk et al., 2008) and HRM practices (e.g. Jimenez-Jimenez & Sanz-Valle, 2008; Kok & Hartog, 2006; Lau & Ngo, 2004; Nasution et al., 2011).

Additionally, Medina and Rufin (2009), in their study on retailers, discovered that market driving has proven to be a powerful determinant of performance as well as innovation, which acts as a mediator between the retailer's strategic orientation and business performance. Han, Kim and Srivastava (1998) also investigated the innovation-mediated effects in market orientation and the corporate performance relationship in the banking industry. Two organizational innovativeness components (technical versus administrative) might help in identifying empirical familiarities or reconciling unfamiliarity in the market orientation and performance relationship, whereby the utility of the market orientation knowledge can be an advance in the business strategies. Meanwhile, Vincent, Bharadwaj and Challagalla (2004) also used innovation as a mediator, as it might influence the environmental, organizational, and financial performance variables. Innovation was selected based on the previous studies, as it can accelerate the chosen variables and performance significantly.

From a different point of view, former studies have shown that HRM practices are the crucial antecedents to accelerate innovation activities and performance (Child, 1972; Jimenez-Jimenez & Sanz-Valle, 2005; Kok & Hartog, 2006; Lau & Ngo, 2004; Mavondo et al., 2005; Shipton et al., 2005). They are among the most accepted and widely-used antecedents in previous studies. Apparently, the competitive environment of business needs a firm to be proactive in their HRM practices, and it leads to the emergence of new inventions and ideas (Jimenez-Jimenez & Sanz-Valle, 2008; Shipton et al., 2005). The advantages of managing human resources give opportunities to attract, develop, motivate, and retain the employees to achieve superior performance (Jackson & Schuler, 1995). Consequently, the innovation activities of the organization can be considered as a catalyst to enhance organizational performance (Jimenez-Jimenez & Sanz-Valle, 2008; Vincent et al., 2004), and thus indicate the fact that innovation might be a mechanism that provides organizations a competitive advantage in the marketplace through their unique resources (Barney, 1991), namely, HRM practices. However, there are very few studies that associate innovation with both determinants and outcomes of innovation (Vincent et al., 2004), and to the researcher's knowledge, a few studies have examined an organizational innovative capability as the main mechanism through which the benefits of HRM practice will enhance organizational performance. Therefore, this study will confirm how the implementation of HRM practices affect the organizational performance, with the organizational innovative capability as the intermediate variable. Accordingly, Kok and Hartog (2006), in their findings proposed to introduce innovativeness as an intermediary in the relationship between HRM practices and performance. Hence, the final proposition is:

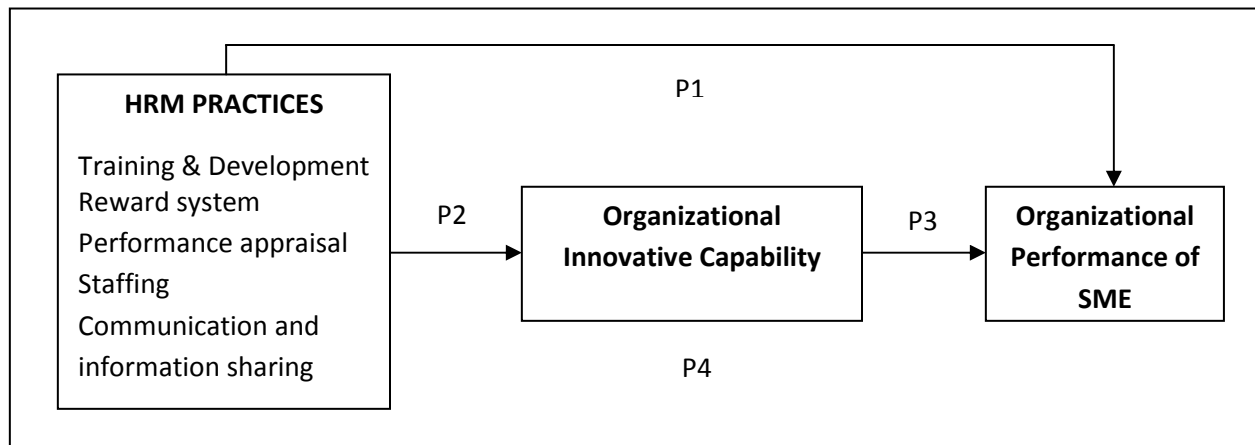
P4 Organizational innovative capability will mediate the relationship between HRM practices (training and development, reward system, performance appraisal, staffing and communication and information sharing) and organizational performance of SMEs.

3. Proposed Conceptual Framework

Based on the preceding discussion of the literature, the following is a proposed conceptual framework (see figure 1). The framework indicates that HRM practices and organizational innovative capability are

associated with organizational performance as well as a mediator role of organizational innovative capability in the relationship between HRM practices and organizational performance. The relationship is based on the resource-based view that suggests that organizational performance is influenced by its organizational resources and capabilities. Firms are able to achieve better performance through the effective use of their organizational resources and capabilities compared to their competitors. Organizational innovative capability is a strategic capability that can affect the organizational performance.

Figure 1
PROPOSED CONCEPTUAL FRAMEWORK



4. Conclusion

This conceptual paper contributes to an understanding of the impact of HRM on SMEs performance generally and particularly in Malaysia. Even though HRM practices have been considered as one of the significant factors appear to boost the performance of organization, it can be said actually most of the Malaysian SME does not practice HRM effectively in their business (Daud & Mohamad, 2010). Hence, Malaysian SMEs have to realize their own competencies, particularly their internal strengths such as the human resource and their HRM practices in order to support SMEs to be innovative and competitive (Ngah & Ibrahim, 2009).

Amidst the global uncertainty and more subdued external environment, SMEs have to adjust themselves to adapt to the changes. In line with the launch of the SME Masterplan 2012-2020, SMEs have to take a new approach to accelerate their growth by focusing on productivity and innovation. SMEs have also been acknowledged as a source for innovation and contribute to forward-thinking ideas that can improve regional economic growth. In fact, the role of innovation has been identified as the key factor affecting the performance of Malaysian SMEs, particularly to drive productivity (NSDC, 2012). Hence, the entrepreneur or owners/managers of SMEs should have the advantage of innovation to compete with larger established businesses in order to succeed in business (Rosenbusch et al., 2011). This suggests that SMEs should engage in a corporate culture that encourages innovation in their organization to remain relevant, competitive, and could have continued success in a newly domestic and global business market. Moreover, previous studies found that organizations that practice more innovative behavior

are likely to initiate organizational changes that could boost organizational performance (Che-Ha & Mohd-Said, 2012; Damanpour & Evan, 1984; Jimenez-Jimenez & Sanz-Valle, 2008; Nghah & Ibrahim, 2009).

According to prior studies, the activities of innovation in organizations have been influenced by individual, organizational, and environmental factors. However, nearly all studies have been focused on organizational factors as key determinants of innovation (Damanpour, 1991; Kimberly & Evanisko, 1981; Vincent et al., 2004). For such organizational factors, human resource management has been approved as the most significant drivers for innovation (Chen & Huang, 2009; Nasution et al., 2011; Tan & Nasurdin, 2010). These HRM practices are capable of providing needed inputs for innovation, which subsequently improve the performance of an organization (Eisenhardt & Martin, 2000; Lopez-Cabrales, Perez-Luno, & Cabrera, 2009; Rhee et al., 2010). This shows that the innovation activities of the organization are a catalyst for improvements in organizational performance (Jimenez-Jimenez & Sanz-Valle, 2008; Vincent et al., 2004), and thus signifying the fact that innovation could possibly become a mechanism that provides the organizations a competitive advantage in the market through unique organizational resources (Barney, 1991), namely, HRM practices. Therefore, this paper will propose, with organizational innovative capability being the mediating variable, how the implementation of HRM practices affects the organizational performance.

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