# The Relationship between Service Culture and Service Innovation: The Mediating Role of Service Orientation

Ferry Tema Atmaja[1], Lizar Alfansi[2], Fachri Eka Saputra[3]

[123] Magister of Management, Faculty of Economics and Business, University of Bengkulu

Abstract. The objective of the study is to investigate the inter-relationship between service culture, service orientation and service innovation in the small-medium enterprises (SMEs) in the city of Bengkulu, Indonesia. A sample of 300 small-medium enterprises in the service industry in the city was employed in the study. Mediated regression analysis was applied to the dataset to examine the proposed model. The result of the study reveals that service culture has a positive effect on service orientation and service innovation of the small-medium enterprises. The study also concludes that service orientation is indeed mediating the relationship between service culture and service innovation. Thus, in implementing a service innovation strategy, small-medium enterprises should build strong service orientation and service culture.

Keywords: **1** Service Orientation · 2 Service Culture · 3 Service Innovation, SMEs.

## 1. INTRODUCTION

SMEs have played a significant role in the Indonesian economy. During the great economic crisis in 1998 and 2008, it was SMEs who were less affected by the financial crisis. According to the head of SME'S development department of Central Bank (called Bank Indonesia) in 2018, the contribution of SMEs to GDP is estimated at 57.56% of the total GDP of Indonesia. Futhermore, the number of SMEs was estimated at 57.89 million, representing 99.99% of business entities in Indonesia (https://finance.detik.com/berita-ekonomi-bisnis/d-4119386/jadi-penggerak-ekonomi-begini-kondisi-umkm-ri).

MacGregor (2004) summarizes the views expressed by researchers about the nature and characteristics of SMEs. According to MacGregor (2004), the nature and characteristics of SMEs can be grouped into four, namely (1) the nature and unique characteristics of SMEs related to management, decision-making and planning processes; (2) the nature and unique characteristics of SMEs with regard to the acquisition of resources; (3) the nature and unique characteristics of SMEs with regard to products/services and markets; and (4) the nature and unique characteristics of SMEs with regard to risk taking and uncertainties that they face.

Competitiveness of SMEs is relatively low compared to that of large businesses. A lack of economic of scale is identified as one of the problem facing SMEs (O'Dwyer *et al.* 2009). Thus, it would be difficult for SMEs to compete in pricing strategies since SMEs cannot gain cost advantage over larger business entities. Poor understanding of marketing is also a serious problem for SMEs. According Gilmor *et al.* (2001) SME marketing is likely to be haphazard, informal, loose, unstructured, spontaneous, reactive, built upon and conforming to industry norm.
Furthermore, Gilmore *et al.* (2001) explain that SMEs have three limitations, namely the limited resources (such as finance, time, and marketing knowledge), lack of specialist expertise, and

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[1] Corresponding Author, Email: arbintangp@gmail.com

limited impact in the marketplace). SMEs view marketing as a function of the sales and promotions without planning in marketing activities (Carson, 1993). In theory and practice, the marketing function is not limited to sales and promotion, but its function includes broader activities such as planning and product development, pricing, customer service, distribution/distribution of products, and so on. With a good understanding of marketing, SMEs can understand consumers better and they can segment and target them more effectively.

Understanding consumers is the key for companies to seize the market and win the competition. Salavou *et al.* (2004) concluded that SMEs operating in highly competitive market tend to be innovative and perform better. Ghosh *et al.* (2001) found that one of the most determining factors in SME business performances is a strong market orientation capability. Slater & Narver (1994) stated that a market-driven business has a good position to anticipate customer needs and meet the ever growing needs by providing a range of innovative products. In similar fashion, Deshpande *et al.* (1993) concluded that innovative companies tend to perform better.

Being innovative is one of the superior characteristics that can be achieved by SMEs (Hughes, 2005). According to Forrest (1990), small companies cannot compete with the use of economies of scale against large companies, but they have a competitive advantage lies in the development of innovative products or innovative processes. In addition to the development of innovative products and processes, SMEs can also initiate and implement innovations in technology and administration (Salavou *et al.*, 2004). According to O'Dwyer *et al.* (2009), when SMEs confront with limited growth conditions and deal with competitors that have large resources, SMEs can compete with combining innovation and pioneering work. Innovation and and pioneering of SMEs are resulted from the adoption of business structure, strategy, and flexible culture. Other opinions of relationship between innovation and corporate culture are expressed by Johne & Davies (2000) and Carroll (2002). Both agreed that SMEs innovation is the implementation of corporate culture that encourages participation, networking, inclusion, and experimentation throughout the organization. Therefore, it is the intention of the study to examine the relationship between service culture, service orientation, and service innovation in the context of SMEs in developing economy such Indonesia.

## 2. LITERATURE REVIEW

### 2.1 Small and Medium Enterprises (SMEs)
SMEs universally stand for small-medium enterprises. It usually refers to small and medium size companies. However, every country has a definition of SMEs, depending on the phase of economic development as well as their prevailing social conditions (Rujirawanich *et al.*, 2011). Various business indicators such as the number of employees, amount of capital, assets, sales, and production capacity have been employed to define SMEs.

In Indonesian, SMEs are classified based on assets and sales. There are three classifications of SMEs in Indonesia as depicted in Table 1.

Table 1 Classification of SMEs according to Law No.20 of 2008

| No. | Description | Criteria | |
|-----|-------------|----------|--|
| | | Asset | Sales |
| 1 | Micro Enterprises | Max. Rp50 Million | Max. Rp300 Million |
| 2 | Small Enterprises | > Rp50 Million-Rp500 Million | > Rp300 Million-Rp 2.5 Billion |
| 3 | Medium Enterprises | > Rp500 Million-10 Billion | >Rp2.5 Billion-Rp50 Billion |

Source: Act No. 20, Republic of Indonesia: Micro, Small and Medium Enterprises

### 2.2 Service Culture

Service culture is defined as a business that puts service as the core of the organization's culture (Curtis & Upchurch, 2008; Teare, 1993). Similar view is also provided by Grönroos (1990, p.244) who defines service culture as "a culture where an appreciation for good service exists, and where giving good service to internal as well as ultimate, external customers is considered by everyone a natural way of life and one of the most important values". Gronroos suggests that service culture means that a company should provide top priority to external customers as well as to internal customers. Providing good services to internal customers will enable employees to provide extra services to customers.

Zeithaml & Bitner (2000) supported the definition of service culture proposed by Grönroos (1990) and considered it as the proper definition of service culture. The definition proposed by Grönroos (1990) according to Zeithaml & Bitner (2000) has three important implications for employee behavior:

1.  Service culture includes "appreciation for providing excellence service". This definition does not only mean the company must have an advertising campaign that emphasizes the importance of service, but in still value to each member of the organization that good service will be appreciated and valued.
2.  Services are provided to both internal and external customers. This definition means that the organization is not enough to make promises for providing excellent service to the final consumer, but all the people in the organization are also eligible to get good service.
3.  Organization that has a good service culture has always put service as "a must" and a pattern of life in the organization because services are most important norms for all members in the organization.

Baydoun *et al.* (2001) argues that the definition of service culture proposed by Gronroos is more precise in describing service orientation or the service climate, namely as a strategy developed by the organization and conducted by the management. However, Lytle *et al.* (1998) claims that service orientation constitutes values and norms that are derived from service culture. Therefore, service culture and service orientation are two different things but inter-related. Some researchers are trying to distinguish between service culture and service orientation. The fundamental difference between the service culture and service orientation lies on the level of analysis (Onstrom *et al*, 2010). Service culture is at the deepest levels of the organization which provides direction for the organization to provide services to consumers in the form of beliefs, values, and assumptions. Companies that have a good service culture will affect all members in the organization to be service-oriented. Service culture is seen as the purpose of the existence of the organization that will be geared towards service orientation as a business strategy in providing the best service to customers. Service orientation, on the other hand, is perceived as environment's perception of organizational services.

The literature suggests that debates on service culture and service orientation persist (Hoang *et al.* 2010). Therefore, an understanding of the differences between service culture and service orientation is indispensable. In the next section we will elaborate further the role of service culture in SMEs.

### 2.3. Organizational Service Orientation

Studies that investigate the service climate within organizations are increasingly gaining interest in academic circles in recent years. Interest of the researchers is stimulated by the results of the study conducted by Lyte *et al.* (1998) and Schneider *et al.* (1998). Their research is based on the strategic philosophy that the organization must achieve competitive advantage through the creation of more value to customers. Value-added can be obtained through the presentation of excellent service to the customer. Lytle & Timmerman (2006) suggested that the presentation of service excellence is not enough just to prioritize the presentation of superior service to external customers but also to provide good service to internal customers. Service-oriented organization

adopts that service excellence is a strategic priority and service greatly affect the creation of superior value, competitive advantage, growth, and profitability (Lytle & Timmerman, 2006).

Lytle *et al.* (p.459, 1998) define organizational service orientation as:

> *"An organization-wide embracement of a basic set of relatively enduring organizational policies, practices, and procedures intended to support and reward service-giving behaviors that create and deliver service excellence".*

On the other hand, Schneider *et al.* (1998) conducted a study to learn about the organizational climate in terms of consumer perceptions of service quality. Schneider *et al.* (p.705, 1998) define service climate as:

> *"Employee perceptions of the events, practices, and procedures as well as their perception of the behaviors that are rewarded, supported, and excepted constitute the climate of the work setting in an organization".*

The similarity in definition raises the issues whether the two constructs are really identical. Lytle *et al.* (1998) argued that service orientation is a dimension of the overall organizational climate. Therefore, policies, practices, and procedures intended to support and reward service-giving behaviors that create and deliver service excellence will provide direct implications for service climate. Kelley (1992) argued that the service climate is one of the characteristics of service delivery and quality of service that distinguishes an organization with another. Kelley (1992) also stated that the outcome of the service climate include individual behavior within organizations. Kelley (1992) implied that the organization has a positive service climate engage in practices, procedures, and policies that encourage certain behaviors of employees in presenting excellent service. Thus, the organizational service climate is seen as the same with organizational service orientation.

### 2.4. Service Innovation

Gadrey *et al.* (1995) define service innovation as an innovation in the service process and innovation in the service product that exist within the organization. Service innovation is described as a development of the activities of the company in providing value added to the core service product to make the core company's product become more attractive in the consumers point of view. Service innovation developed tends to involve interaction with consumer products and services associated with existing or new service products. Johne & Storey (1997) argued that the company should develop appropriate products and services according to consumer interest since the interaction is an important part of the services company offers. Service innovation then adapted to a variety of value-added in delivery of products or services can enhance the customer service experience. Service innovation can be influenced or influence the company's core service products.

Being innovative is one of the superior characteristics owned SMEs (Hughes, 2005). Forrest (1990) stated that small companies cannot compete with the use of economies of scale against large companies, but they have a competitive advantage lying in the development of innovative products or processes. In addition to the development of innovative products and processes, SMEs can also initiate and implement innovations in technology and administration (Salavou *et al.*, 2004). According to O'Dwyer *et al.* (2009), as SMEs face limited growth conditions and deal with competitors that have large resources; SMEs can compete with the combined innovation and pioneering work. Innovation and pioneering SMEs resulting from the adoption business structure, strategy and culture are flexible.

Innovation is an important factor in maintaining continuity of business growth (Christensen & Raynor, 2003). For SMEs, innovation is a key factor of success in maintaining growth and business continuity. The concept of innovation in the organization can steer the organization in a creative work climate. Innovation is able to create a work culture that can facilitate ideal working environment as well as being a potential strength for the organization (Ismail, 2005). Creativity is

a process of thinking that is capable of generating ideas (Majaro, 1992). In the SMEs, innovation is also seen as a process of creating a new product or service commercially produced (Ismail, 2005). The resulting innovations may be technological innovation and non-technological innovation.

### 2.5. Research Framework
From the literature review that was conducted by the researchers, the research model was composed as follows:
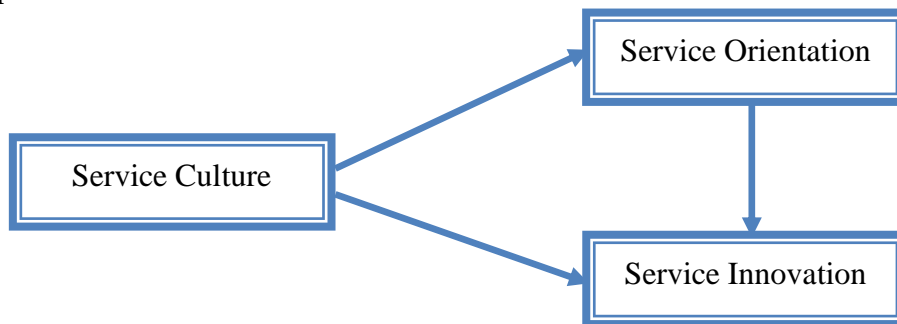


Figure 1 Research Framework
Developed from research by Lytle *et al.* (1998); Nelson (2007); and Grawe *et al.* (2009)

## 3. RESERACH METHOD
The purposes of the study are to explain and to examine the influence of service culture and service orientation on service innovation. In addition, the role of service orientation in mediating the relationship between service culture and service innovation is also investigated in this study. Therefore, a mediated regression is developed for the study.

Owners and managers of (SMEs) in the city of Bengkulu are sampled for the survey. Researchers do not restrict the types of businesses chosen for the study. McDermott & Prajogo (2012) stated that using various types of businesses for the data sampled may increase the generalizability of research results. Researchers determined owners and managers as a sample unit with the assumption that the characteristic of the research constructs employed in this study is better measured from the perspective of leaders or owners due to the complexity of organizational culture measurement.

A non-probabilistic sampling was employed for the survey. Three hundred questionnaires were distributed and 250 completed questionnaires were utilized for the analysis. To answer the purposes of the study, researchers employed mediated regression analysis. A four-stage approach of mediated regression as proposed by Baron & Kenny (1986) was employed in the model. A model of relationship between service culture and service innovation mediated by service orientation is depicted in the following figure.
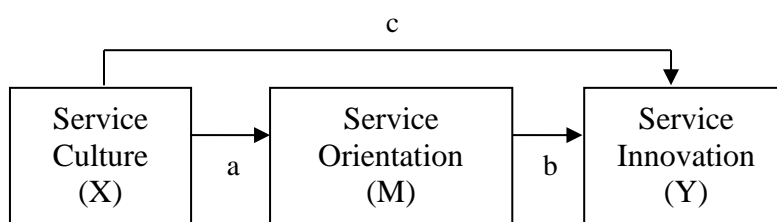


Figure 2 the role of service orientation as a mediating variable

Stages of testing the mediating role of service orientation in the relationship between service culture and service innovation are summarized in Table 2.

Table 2 Testing mediation of the service orientation variable

| Stages | Analysis |
|---|---|
| First Stages | Conduct a simple regression analysis of the relationship between variable X and variable Y. The relationship is coded "c" in the path diagram. $Y = B_0 + B_1X + e$ |
| Second Stages | Conduct a simple regression analysis of the relationship between variable X and variable M. The relationship is coded "a" in the path diagram. $M = B_0 + B_1X + e$ |
| Third Stages | Conduct a simple regression analysis of the relationship between variable M and variable Y. The relationship is coded "b" in the path diagram. $Y = B_0 + B_1M + e$ |
| Fourth Stages | Conduct multiple regression analysis of the relationship between the variables X and M to variable Y. $Y = B_0 + B_1X + B_1M + e$ |

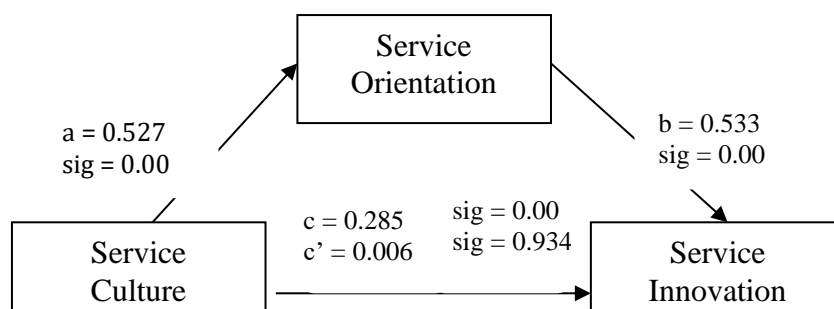Source: http://davidakenny.net/cm/mediate.htm

The role of mediating variable service orientation is indicated if the following conditions are met:
1. In the first equation, the independent variable must affect the dependent variable (X affects Y).
2. In the second one, the independent variable must affect the mediating variable (X effect on M).
3. In the last equation, mediating variable must affect the dependent variable (M effect on Y).

The objective of the first stage to the third stage is to illustrate whether there is a relationship partially on the proposed three latent variables. If one or more existing relationship is not significant, researchers usually conclude that mediation does not happen or is not possible to occur (although these predictions are not always correct, See MacKinnon *et al.*, 2007; Baron & Kenny, 1986). If it is assumed that there is a significant relationship from the first stage to the third stage, the mediating role of testing can be seen by looking at the results of the regression analysis on fourth stages. In the fourth stage, a full mediation occurs when the mediating variables influence the dependent variable significantly while the effect of independent variables on the mediating variables is not significant. Conversely, if the effect of mediating variables on the dependent variable is significant and the impact of independent variables on the mediating variables is also significant, it can be said that the findings support the partial mediation effect.

## 4. RESULT AND DISCUSSION

The results of the analysis prove that the service orientation variable fully mediated the relationship between service culture and service innovation in the SMEs sector in the city of Bengkulu. Schematic relationship of the variables is depicted in Figure 3.



Service Orientation

a = 0.527
sig = 0.00

b = 0.533
sig = 0.00

Service Culture

c = 0.285
c' = 0.006

sig = 0.00
sig = 0.934

Service Innovation

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Figure 3 the Research Result

The results of hypothesis testing show that *service culture has a significant and positive effect on service innovation* in SMEs. The result of the study indicates that service innovation in the SMEs is influenced by service culture in the organizations of SMEs. Culture is the spirit that drives the organization. Culture describes values and norms and is understood as a guide and reference for every member in the organization. Companies that have a strong service culture will place the service in the top priority in organizational strategies that will lead to the presentation of excellent service to the consumers. These research findings are also supported by the findings of several previous studies. Johne & Davies (2000) and Carroll (2002) suggested that service-oriented organizational culture can support the level of creativity and innovation for all members in the organization who will eventually provide innovative services for external customers. Some researchers also believe that SMEs are more flexible to do innovation compare to large companies. Large firms will need expensive cost of research and development of R&D department support innovations (Chen *et al.,* 2009; Umashankar *et al.,* 2011). Therefore, it is important for SMEs to develop a strong service culture within the organization since it help SMEs to achieve a well-uquipped service innovation strategies.

The hypothesis testing also concludes that *service culture has a significant and positive effect on service orientation.* The result of the study supports a hypothesis that a strong service culture within the organization will improve the practice of service orientation of SMEs. In other words, for SMEs to have a good practice of service orientation, they need to develop a strong service culture.

These results of the analysis also confirm that *service orientation has a positive effect on service innovation.* The results suggest that SMEs can have effective innovation strategy if they have a good level of service orientation. Service innovation is closely related to service orientation and service culture. Companies that have a strong service culture will tend to be oriented toward the presentation of excellent service. Excellent service can be achieved if the company anticipates dynamic environmental changes. Changes in the market environment should be followed by innovating services according to the changing demands of consumers. The results of this study suggest that the business strategy that puts service innovation as a core strategy to achieve a competitive advantage would be difficult if the company does not have a focus on service orientation. Innovation processes within an organization occurs when there is a need to all members in the organization to provide the best service to customers. The need to always provide good service to customers can be achieved if organizations put policies and service orientation as a business strategy. Thus, the influence of service orientation on service innovation is also evident in this study.

Research findings also provide empirical evidence that *service orientation mediates the relationship between service cultures on service innovation* in the SMEs. The impact of the relationship seems to be relevant since culture create value and must be adhered to and implemented by all members in the organization. Values and norms are then operationalized into practices, procedures, and policies toward the provision and delivery of excellent customer service (Gronroos, 1990; Lytle *et al.,* 1998; Lytle & Timmerman, 2006). Culture can be illustrated as a vision for a company, which is the spirit of the company, which will bring the company towards the goal to be achieved. Thus, vision must be translated into mission, so it can be operational and well executed by all members in the organization. The mission is then illustrated as service orientation. Outputs from the vision and mission, service innovation, is the achievement of results obtained by the company in the form of continuous service improvement. This explanation seems logical, showing the linkage among service culture, service orientation and service innovation. Service innovation will not be realized if the company is unable to instill the values and norms of services

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to employees. Values and norms of the service also will not run well if not operationalized into the practices, procedures, and policies in support of the company's presentation of excellent service. Thus, the role of service orientation in mediating the relationship between service culture and service innovation is approved in this study.

In conclusion, the study finds the following pattern of relationships among the constructs in the SMEs in the city of Bengkulu:
1. Service culture has a positive effect on service innovation.
2. Service culture has a positive effect on service orientation.
3. Service orientation has a positive effect on service innovation in the SMEs sector in Bengkulu.
4. Service orientation mediates the relationship between service culture and service innovation.


## 5. CONCLUSION

The result of the analysis concludes that service culture plays a very strategic role as an estuary in achieving service excellence as well as creative and innovative behavior of employees in business organizations. Values and norms resulted from service culture have a positive effect on the creation of practices, procedures, and policies that focus on providing excellent service to customers. Excellent services gained from implementing service orientation will create a variety of business innovation in the company in providing value added to the core products or core services within organizations. This in turn can promote the establishment of quality services more attractive and innovative in the eyes of consumers so as to provide a unique competitive advantage for the SMEs.

The results of this study provide some insights for SMEs in implementing a service innovation strategy, as being innovative is a key strategic goal for SMEs to survive and thrive in an ever changing business environment. However, to set up an effective innovation strategy, SMEs need to build a strong service culture as the latter has a strong influence on service innovation. Building a strong service culture will certainly take time, investment, and leadership commitment. The result of the study also indicates the role of service orientation in mediating the relationship between service culture and service innovation. Therefore, to fully gain advantages in implementing a service innovation strategy, improving the level of service orientation practices for SMEs is prerequisite. Thus, in implementing innovation strategies SMEs should pay attention to the rule of service culture and service orientation as both constructs are equally important in achieving service innovation.

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