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## Article

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Journal of Global Entrepreneurship Research

## Provided in Cooperation with:

Springer Nature

*Suggested Citation:* Pratono, Aluisius; Mahmood, Rosli (2015) : Mediating effect of marketing capability and reward philosophy in the relationship between entrepreneurial orientation and firm performance, Journal of Global Entrepreneurship Research, ISSN 2251-7316, Springer, Heidelberg, Vol. 5, Iss. 5, pp. 1-12,  
<https://doi.org/10.1186/s40497-015-0023-x>

This Version is available at:

<https://hdl.handle.net/10419/161766>

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RESEARCH

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# Mediating effect of marketing capability and reward philosophy in the relationship between entrepreneurial orientation and firm performance

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## Abstract

The complex relationship between firm performance and entrepreneurial resources raises attention to development program with aim of promoting entrepreneurial mindset to the SMEs. This study has intention to determine the impact of entrepreneurial orientation on firm performance, which involves two mediating variables: reward philosophy and marketing capability. Reward philosophy and incentive system are the most under-researched area in human resource, especially in the context of small business. With SMEs data survey in Indonesia, the result reveals that reward philosophy is not sufficient to explain the relationship between entrepreneurial orientation and firm performance. It requires marketing capability, which can transform reward philosophy to performance. This study contributes to the development of resource-based theory, through discussing the role of dynamic capability. The research uses quantitative approach with the SMEs in Surabaya as unit analysis. Data analysis involves 390 SMEs taken from random sample selection process. The analysis involves descriptive, regression and structural equation modeling (SEM) approaches to test the hypotheses. The finding explains full mediating effect of employee compensation and marketing capability in converting entrepreneurial orientation to gain greater firm performance.

**Keywords:** Firm performance; Entrepreneurial orientation; Reward philosophy; Marketing capability

## Background

Small and medium enterprises (SMEs) have been acknowledged as a driving force to foster economic growth and job creations. Various programs with aim of promoting entrepreneurial approaches among SMEs become popular among policy makers in around the world, including Indonesia. The fact that Indonesia SMEs contribute to 97.2 percent of employments and 57 percent of total Gross Domestic Products (Indonesia SME Ministry, 2013) has brought attention to policy makers, academicians, and social workers. However, the relationship between firm performance and entrepreneurial orientation has raised attention in the context of SMEs, especially when the expected target seems to be a long way.

There is a main argument that entrepreneurial orientation (EO) provides positive impact on firm performance (FP). The strong relationship between EO and performance has been acknowledged in across economies (Saeed, Yousafzai, & Engelen, 2014). Specifically, EO contributes to firm growth (Moreno & Casilas, 2008), sales growth

(Simon, Stachel, & Covin, 2011), and overall performance (Mahmood & Hanafi, 2013). On the other hand, some argue that the relationship between EO and FP could be negative or insignificant for some reasons, such as business cycle (Andersén, 2010) or non-linear relationship (Kreiser, Marino, Kuratno, & Weaver, 2013). This calls for mediating role to understand the complex relationship between EO and FP (Qureshi & Kratzer, 2012).

Reward philosophy is acknowledged as valuable mechanism to transform entrepreneurial resources into firm performance. Compensation and incentive system are the most under-researched area in human resource, especially in the context of small business (Gupta & Shaw, 2014). In the context of entrepreneur approach, reward philosophy allows employee compensation to lay emphasis on innovation (Bradley, Wiklund, & Shepherd, 2011). However, there is a strong tendency that SMEs suffer from poor labor productivity even after raising wage. This occurs with Indonesia between 2000 and 2011, when minimum wage steadily increased by 5.5 percent. In comparison, between 2000 and 2011, workers in China, Thailand, and Vietnam also experienced wage growth, 8.4 percent, 14.2 percent, and 6.7 percent respectively, but they experience a better performance (Aswicahyono, Brooks, & Manning, 2013). The main previous contributions have focused on single and specific measures, such as strategic orientation or entrepreneurial orientation, and their relationship to firm performance (Lowe et al., 2010). The entrepreneurship field is also challenging some issues regarding lack of agreement, which brings into limited and slow development of a cumulative body of knowledge (Rauch et al., 2009).

On the other hand, the workers in SMEs also suffer for poor human resource system. In Indonesia context, the informal workers comprise 70% of workforces. They work with a very low wage, irregular working time, and no social security (BPS Statistics Indonesia & Asian Development Bank, 2010). Reward philosophy is one of the most critical issues for competitive advantage of the firm. This concept lays emphasis on innovation. Firms provide greater reward for innovative employees, which becomes direction of strategic of the firm (Puranam, Alexy, & Reitzig, 2013). This allows reward philosophy with entrepreneurial context to be aligned with business strategy. However, increasing compensation may bring a tight compensation budget for the firms. This raises debates on the degree of match between firms and their employees through improvement in effort-reward balance.

The challenges come to transformation process of such resources into performance, especially since it embedded in employees. To understand the complex relationship among performance, reward philosophy and entrepreneurial orientation, it may be useful to consider marketing capability as a mediating variable; especially from the role of product development (Qureshi & Kratzer, 2012). Firms with greater entrepreneurial orientation (EO) and reward philosophy may fail to achieve their target unless they gain greater marketing capability (MC).

This article has intention to determine the mediating role of reward philosophy and marketing capability to firm performance Baker et al. (2009) Specifically, the contribution focus on how the reward philosophy and marketing capability explains the relation between entrepreneurial orientation and firm performance. This study considers that reward philosophy and marketing capability involve in transformation process from resources into SMEs performance requires mediating process. The research uses quantitative approach with the SMEs in Surabaya as unit analysis. Data analysis involves 390 SMEs taken from random sample selection process. The analysis involves descriptive, regression and structural equation modeling (SEM) approaches to test the hypotheses.

### Literature review

This study underpins resource-based view (RBV), which underlines the way firms utilize their resources to achieve performance. Resource-based theory views on the firm performance from the broaden perspective toward global sustainability. The concept of RBV has been developing for decades, from classical works with firm growth theory to competitive advantage theory and dynamic capability theory. The RBV classic works argue that the growth of the firm requires recruitment of more such resources (Penrose, 1959). RBT also has valuable contribution to identify main determinants of firm performance and competitive advantage theory by focusing on developing a new capability (Barney, 2001). As intangible resources, entrepreneurial orientation (EO) refers to efforts of entrepreneurs to seize business opportunities, which constitutes proactive behavior, innovation driven, and risk-seeking ability (Covin & Wales, 2012). Specifically, human resource constitutes the knowledge, skills, networks personalities, and motivation, which allow developing specific capability (Boxal, 2013).

The RBV has strong relationship with a concept of competitive advantage. Such resources are believed to be key elements for firms to gain superior performance. Competitive advantage occurs whenever firms achieve the greater performance than their competitors (Porter, 1998). Firms with resource position barrier will be able to maintain their bargaining position. In the context of SMEs, a patent holder is the best example to explain appropriate part of his license holder. This occurs when a small advertising firm may take a share of image builders from the customer profit (Wernerfelt 1984). Apparently, larger-size firms have more opportunities than the smaller one in resource ownership, especially to acquire qualified personnel in research and development for innovation (Bakar & Ahmad, 2010).

Barney (2001) develops the criteria of valuable resources, such as perfectly inimitable and immobile, which prompts more competitive advantage. In addition, such characteristic is considered as necessary but not sufficient to promote sustainable competitive advantage (Priem & Butler, 2001). However, there is risk of poor synergies among such resources, including asymmetric information, which implies on underestimated resources (Warnier, Weppe, & Lecocq, 2013). The underestimate resources may bring failure of incentive system, co-specialization or co-development of resources (Huesch, 2013).

Reward philosophy is one of the most critical issues for competitive advantage of the firm. This concept lays emphasis on innovation. Firms provide greater reward for innovative employees, which becomes direction of strategic of the firm (Puranam, Alexy, & Reitzig, 2013). This allows reward philosophy with entrepreneurial context to be aligned with business strategy. However, increasing compensation may bring a tight compensation budget for the firms. This raises debates on the degree of match between firms and their employees through improvement in effort-reward balance. Motivation of employees to develop innovation is not only an interest to use and sell it but also enjoyment and learning gained from the innovation process (Christina & von Hippel, 2013). However, increasing compensation may bring a tight compensation budget for the firms. This raises debates on the degree of match between firms and their employees through improvement in effort-reward balance.

Motivation theory indicates that team-based payment system aims to encourage team members to support organization growth. As a firm is considered as a team, the reward

system is designed to promote partnership that supports the goal of the firm. This system argues that team members accede to favor equality-based reward over equity base one (Bamberger & Levi, 2009). Better assessment of true rewards will enable firms to encourage their workers to achieve the best performance.

The dynamic capability has become main attention since RBV is not sufficient to explain sustainable competitive advantage. Dynamic capabilities theory provides explanation on how firms value-creating strategies meet dynamic market to gain long-term competitive advantage (Eisenman, 2013). Firms with capability to control scarce and unique resources have more opportunities to achieve superior profit. Along with market power, firms typically have two optional decisions to gain economic profit: increasing the number of output or decreasing the price of output. Firms that deploy their unique resources and increase their output may trigger their competitors to decrease their output (Costa, Cool, & Dierickx, 2013).

## **Research design**

### ***Operational definition***

This section provides operational definition of the terms and variables in which the study uses at the operational model.

1. Small and Medium Enterprise (SME) is combination of two concepts of firm size, i.e. small and medium firms. The criteria of SMEs follow the Indonesian regulation, Law No 80/2008, which states that small enterprise is a firm with asset range between Rp50 million and 500 million as well as sales between Rp300 million and Rp2.5 billion per annum, while medium enterprise is a firm with annual sales from 2.5 billion to Rp50 billion. Hence, small and medium enterprise refers to a firm with asset between Rp50 million and Rp10 billion and sales between Rp300 million and Rp50 billion.
2. Firm performance (FP) refers to level of achievement of business organization toward its goal of business organization: profit maximization. Hence, sustainable profit maximization is associated with some measure items, which are sales growth, employment growth, gross profit, return on asset, return on investment, and return on sales (Aziz & Mahmood, 2011).
3. Entrepreneurial orientation (EO) refers to decision-making approaches, which becomes attributes of many successful firms. This is about strategic posture, which enables firms to draw on entrepreneurial skills and capabilities in order to seize opportunity (Covin & Wales, 2012). Firm with greater EO tend to edge take risk, innovate and act proactively, while conservative firms prefer to avoid risk, reluctant to innovate, and act reactively (Lumpkin, Cogliser, & Schenider, 2009).
4. Reward philosophy (REWARD) is mechanism in human resource management, which adopts entrepreneurial behavior (Gürbüz & Aykol, 2009). Firms with a greater reward philosophy tend to set compensation with strong intention to promote innovativeness (Bradley, Wiklund, & Shepherd, 2011).
5. Marketing capability (MC) refers to capability to handle marketing mix strategy, i.e. covering pricing, selling, communication and product development. The capability enables firms to set and implement new strategies to meet firm performance as organization's goal through responding to changing market condition (Morgan, Vorhies, & Mason, 2009).

### **Hypothesis development**

This study proposes a theoretical framework (figure 1) with five hypotheses. The hypotheses can be found as bellow:

**Hypothesis 1: EO has a direct impact on FP** Entrepreneurial orientation (EO) is believed to be a valuable resource, which allows firms to achieve their performance. The strong relationship between entrepreneurial behavior and FP has been acknowledged since several decades ago with main incidence that EO has positive effect on firm performance (Kreiser, Marino, Kuratno, & Weaver, 2013). The novel literature comes from Miller and Friesen (1978), who identified the construct of entrepreneurial orientation. Then, a number of researches show a positive impact of EO on performance, especially the contribution of EO on firm growth (Moreno & Casilas, 2008), profit (Baker & Sinkula, 2009), sales growth (Simon, Stachel, & Covin, 2011), and overall performance (Mahmood & Hanafi, 2013). Then, this article proposes first hypothesis that EO has positive impact on FP. On the other hand, some literatures provide different evident that relationship between EO and FP is not always positive and significant. The reason may lie on business cycle (Runyan, Droge, & Swinney, 2008) and ignoring the failure of risk-taking behavior (Andersén, 2010). Kreiser et al (2013) also highlight the non-linear relationship between EO and FP. This calls for mediating role to understand such complex relationship (Qureshi & Kratzer, 2012).

**Hypothesis 2: REWARD mediates the relationship between EO and FP** Identifying a mediating variable is typical approach to refine theory regarding process and to understand a complex causal relationship (Rucker, Preacher, Tormala, & Petty, 2011). Mediating variables illustrate the transmission mechanism between independent and dependent variable, such as EO and performance. Some partial evidences for mediation effects from previous studies provide inside idea to introduce a mediating variable (Harms, 2013). The role of reward philosophy as mediating variable comes from some reasons. First, firms with high EO have a greater willingness to take risks and promote innovation, which has consequence of higher rewards (Filser, Eggers, Kraus, & Malovics, 2014). In the context of SMEs, the firms consider both risks associated with failure rate and low reward to self-employment. The firms make commitment to risk-taking initiative with appropriate reward systems to support their employees seem particularly helpful. Firms with limited resource iterate to discover the essential business opportunity to ensuring their continued survival (Mousa & Wales, 2012). The venture success becomes the most important attribute to determine financial reward in which job risk and pay risk embedded. Private equity acquisition with lower wages and poor productivity has negative employment consequence (Goergen, O'Sullivan, & Wood, 2011).

**Hypothesis 3: REWARD mediates the relationship between EO and MC** Shin and Aiken (2012) also consider marketing capabilities (MC) as an essential driver for converting valuable resources to firm performance. A firm with a strong EO and a developed reward system, but it requires MC to convert those resources into commercial viable products or services. The role of MC as mediating variable may explain relationship between EO and FP, which refers to profitability and uniqueness product as

competitive advantage (Qureshi & Kratzer, 2012). The empirical results reveal positive impact of entrepreneurial orientation on marketing capability. Hence, MC has significant impact on FP (Para-Requena, Ruiz-Ortega, & Garcia-Villaverde, 2012). Along with marketing capability, process of transforming entrepreneurial orientation to firm performance involves incentive system, which enables product development to gain firm performance. Andersén (2010) points out that EO in large corporations has developed a reward philosophy, a training division and designation a manager to promote new ideas. This aims to foster employee's creativity and innovation techniques, while designation of manager has responsibility toward championing new ideas. The higher proportion of employment in skilled jobs the higher role specialization and absorptive capacity (Gammelgaard, McDonald, Tuselmann, & Stephan, 2011).

**Hypothesis 4: MC mediates the relationship between EO and FP** The impact of compensation plays pivotal role in organization effectiveness through improving quality of human capital and performance level of the workforce. Compensation shapes employees behavior and organization effectiveness (Gupta & Shaw, 2014). The relationships of group incentives and financial performance are stronger in companies with higher innovative companies (Park & Kruse, 2014).

**Hypothesis 5: MC mediates the relationship between REWARD and FP** Strategic HRM develops internal capacity to deal with competitive environments by aligning the policies and practices, including investment in human resource practice to enhance the value of their employees (Campbell, 2013). HR is about a concern on providing reasonable performance appraisal as well as incentive salaries. However, the financial rewards of entrepreneurship could be multifaceted due to different types and amounts of rewards at different stages of the business life cycle (Carter, 2011). Reward philosophy needs lays emphasis on a leader reward behavior, which implies on overall organizational behavior and intention to turnover of the employees. Reward is positively related to higher task performance and organizational citizenship behavior, and fewer intentions to turnover (Jackson, 2008). Reward system may have no a significant effect on marketing and sales interface due to imperfect market. Reward philosophy is associated with leader reward behavior, which implies on overall organizational behavior and intention to turnover of the employees. Marketing capability (MC) is an essential driver for converting valuable resources to firm performance (Shin & Aiken, 2012). A firm might have strong EO and developed reward system, but it requires MC to convert those resources into commercial viable products or services. The mediating role of MC may explain relationship between EO and FP, which refers to profitability and uniqueness product as competitive advantage (Qureshi & Kratzer, 2012). Wang & Singh (2014) consider that the employee rewards is associated with organization life cycle (Figure 1).

## Methods

This research work uses quantitative method with cross-section design. The construct measures are adapted from four major references followed by questionnaires distribution to 800 respondents, which selected from random from Surabaya SMEs database.

Self-administration approach is used to increase willingness of honest answer and to gain a wider geographical coverage. Hence, 390 respondents contribute to this study.

The analysis uses structural equation model (SEM) to test the hypothesis. The six latent variables are adapted from some major references. Firm performance adapts from Aziz and Mahmood (2011). Entrepreneurial orientation refers to Lumpkin et al. (2009). Marketing capability refers to Morgan et al. (2009). Employee compensation refers to Bradley et al. (2011) and Gürbüz and Aykol (2009).

This study uses partial least square (PLS) to test hypothesis with structural equation model (SEM). PLS is considered with the ability to analysis outer model or latent variables analysis. PLS is also powerful to analysis structural model or inner model analysis, which tests the relationship between latent variables. To deal with such bias estimation, each construct's AVE (average variance extracted) should greater than the squared correlation among the constructs, part coefficients should come from bootstrapping, and report of t-value, p-value, and indicating weight should be in place (Hair, Sarstend, Ringle, & Mena, 2012).

## Result

Data collection shows that the observed firms represent small and medium enterprise in Surabaya Indonesia. Observed firms with asset between Rp50 million and Rp10 billion were 60%. This indicates that most of them represent medium firms. However, from the number of sales, the data shows that 61% of them have annual sales between Rp300 million and Rp2.5 billion, which indicates that the observed data comes from small firms.

Table 1 reports mean, standard deviation and correlation among the observed variables. With range data from 1 for lowest performance to 7 for greatest performance, the observed firms have moderate firm performance at level 4.86 of average. EO, Reward, and MC also show moderate level with average rate range at 4.

Reliability test adopts quality criteria, which composes of Composite Reliability (CR) and Cronbach Alpha (CA). The CR measurement shows that all variables have coefficient greater than 0.9. This result implies that all variables are accepted reliability. The measure of average variance extracted (AVE) shows that all variables have greater number than 0.6. This result indicates that all variables are adequate convergent validity (see Table 2).

Figure 2 and Table 3 shows that the path analysis, which indicates that there is no significant relationship between EO and FP, since the t-test is 1.3. T-table with sample greater than 100 shows that t-statistics for two tails should be 1.96 for alpha 5%. This indicates that H1 is rejected, which implies no direct effect between EO and FP.

**Table 1 Descriptive statistic and correlations**

	Mean	Std. Dev.	1	2	3	4
1. Firm Performance (FP)	4.8630	1.29939	1.00			
2. Entrepreneurial Orientation (EO)	4.2984	1.06294	0.432*	1.00		
3. Reward Philosophy (Reward)	4.9564	1.47266	0.488*	0.408*	1.00	
4. Marketing Capability (MC)	4.8780	1.45184	0.641*	0.577*	0.577*	1.00

\*significant with alpha = 5%.

**Table 2 Reliability test**

Variable	AVE	Composite Reliability	Cronbachs Alpha	Communality
EO	0.617141	0.905910	0.874983	0.617141
FP	0.652254	0.929106	0.910873	0.652254
MC	0.656749	0.918664	0.890981	0.656749
Reward	0.645447	0.900499	0.861421	0.645447

The bootstrap output shows the impact of EO on RP is significant (Figure 2 and Table 3). With t-statistics of 5.04, the significant relationship between EO and RP shows that H2 is accepted. Figure 3 shows that there is positive coefficient which means that firms with greater entrepreneurial orientation to be risk taker, innovator and proactive have greater interest to develop employee compensation. In addition, the relationship between EO and MC is also significant with alpha 1%. Hence, H3 is accepted with positive coefficient (Figure 3), which indicates that firms with greater entrepreneurial orientation has greater marketing capability.

Reward philosophy has mediating effect on the effect of EO on MC. However, this not happens with EO and FC. There is no direct impact of RC on FP. The out shows that the relationship between EC and FP is not significant with the t-test 1.5 or less than t-table and alpha >.05. This indicates that H4 is rejected. The relationship between RP and MC is also significant with alpha 1% (Figure 2 and Table 3). Figure 3 shows positive coefficient, which indicates that firms with the greater employee compensation system will have greater marketing capability.

The path analysis shows that H6 is accepted with alpha 1% that MC has significant impact on FP (Figure 2 and Table 3). Inner model evaluation shows that marketing capability has full mediating effect within the model. On the other hand, marketing capability mediates the relationship between employee compensation and firm performance as well as the relationship between entrepreneurial orientation and firm performance (Figure 3).

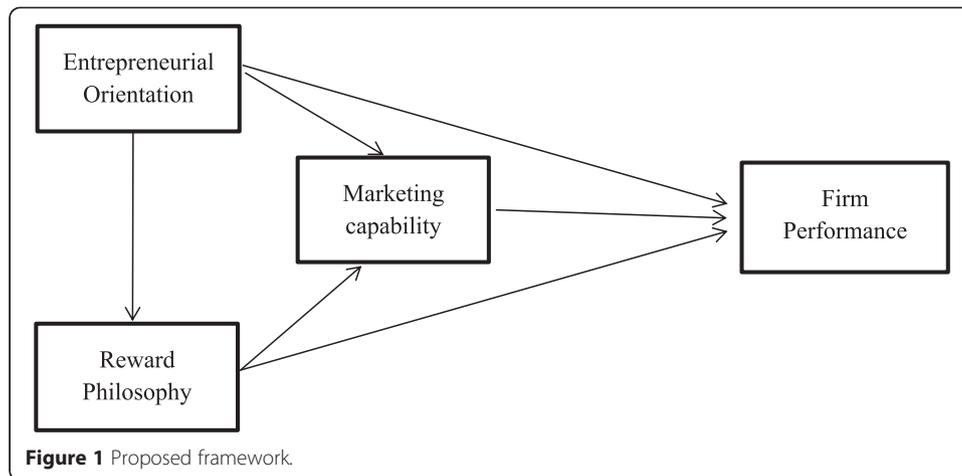
**Discussion**

This study provides evident that there is no direct effect of EO on FP. The previous studies support the result and argue that the insignificant relationship between EO and FP lays on some reasons, including business cycle time frame and risk aversion (Andersén, 2010). Another reason for insignificant relationship may come from statistical approaches, such as outweighed effect from other variables (Runyan, Droge, & Swinney, 2008). Hence, the involving mediating variable may explain the complex relationship between EO and FP.

**Table 3 Path analysis**

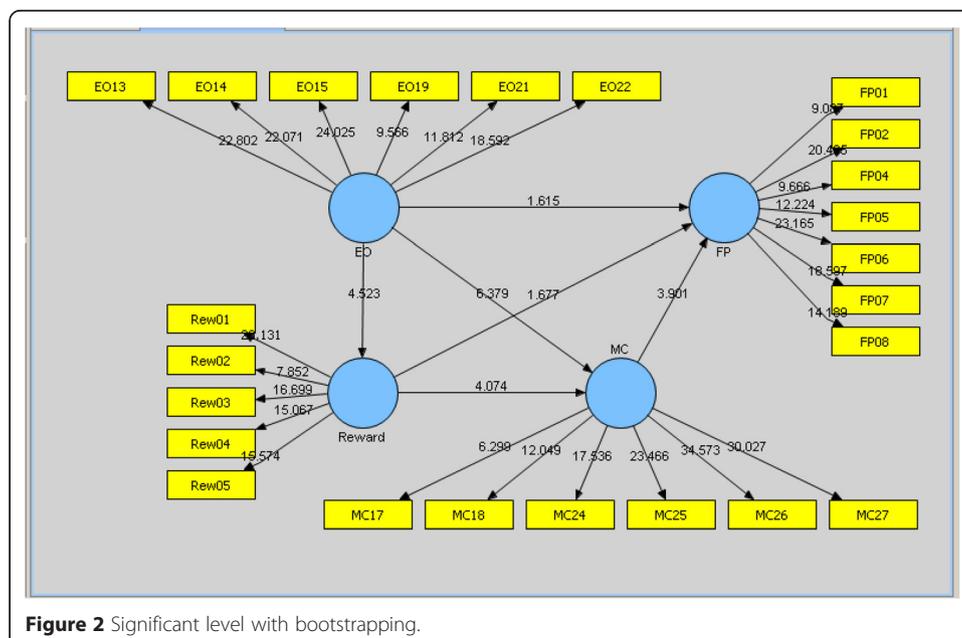
	Sample Mean	Standard Deviation	Standard Error	t-statistics
EO -> FP	0.147548	0.122217	0.122217	1.284483
EO -> Reward***	0.440593	0.086018	0.086018	5.045719
EO -> MC***	0.467851	0.085744	0.085744	5.444087
Reward -> FP	0.192813	0.118617	0.118617	1.533107
Reward -> MC***	0.369703	0.096598	0.096598	3.803890
MC -> FP***	0.441131	0.125679	0.125679	3.516021

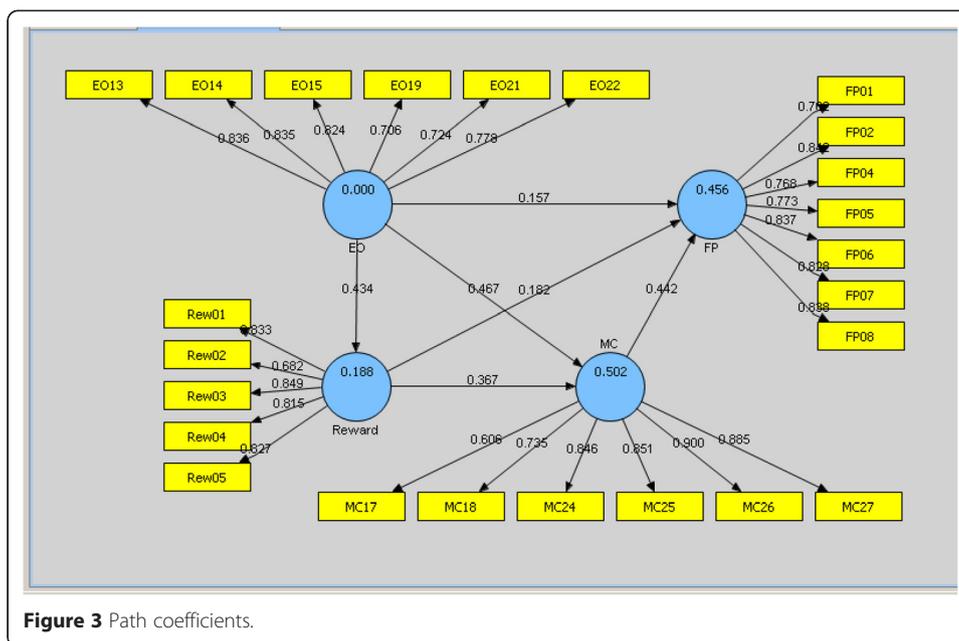
\*\*\*significant with alpha = 1%.



The study also indicates that EO has significant impact on Reward, while Reward has no direct effect on FP. The previous study indicates that reward system has no significant effect on sales performance (Rouzies, Hulland, & Barclay, 2010). This implies that firms with greater EO have greater reward philosophy. This is in line with the previous study that firms with greater EO proactive have greater interest to develop Reward (Fisser, Eggers, Kraus, & Malovics, 2014).

MC plays pivotal role to explain the relationship between EO and FP. MC has moderating effect not only between EO and FP but also between Reward and FP. Reward has important role on organization capability, including task performance and organizational citizenship (Jackson, 2008). The full mediating effect of MC explains the complex relationship between EO and FP, which implies on profitability and uniqueness product as competitive advantage (Qureshi & Kratzer, 2012).





**Figure 3** Path coefficients.

Firms might have strong EO and developed reward system, but they require MC to convert those resources into commercial viable products or services. Previous studies support the argument that EO can bring positive result in MC (Lee & Hsieh, 2010) and MC has significant impact on FP (Para-Requena, Ruiz-Ortega, & Garcia-Villaverde, 2012).

The implication of this result suggests that SMEs should pay more attention on marketing capability. As marketing and other activities have no strict job division, the employee compensation can be associated with reward for marketing capability indicates to greater accountability in marketing management (Homburg et al., 2012).

The limitation of this study springs from cross section data observation, which implies on snap shoot observation. Panel data analysis is also encouraged to fulfill the research gap. The source of information relies on the owner managers. The future study should involve multiple source of information from the observed firms, such as owner, workers, suppliers, and other stakeholders.

**Conclusion**

There is paradoxical result of a unique resource deployment as the relationship between EO and FP is complicated. This study provides valuable extension for the perspective of resource-based theory, which explains on how it is necessary for firms to value their entrepreneurial orientation resources through developing employee compensation system and enhancing marketing capability. This study gains support from the advanced RBV theory that highlights the role of capability to manage the resources. Firms with capability to control unique resources and to handle market power have more opportunities to achieve superior profit.

**Abbreviations**

FP: Firm performance; EO: Entrepreneurial orientation; MC: Marketing capability; Reward: Reward philosophy; SMEs: Small and medium enterprises; RBV: Resource based value.

**Competing interests**

The authors declare that they have no competing interests.

**Authors' contributions**

AHP and RM designed the model and analysis. AHP carried out the survey and empirical test. Both authors read and approved the final manuscript.

**Acknowledgements**

This research was partly supported by Universiti Utara Malaysia.

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Received: 11 August 2014 Accepted: 16 April 2015

Published online: 08 May 2015

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