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RESEARCH ARTICLE

**THE EFFECT OF ENVIRONMENTAL DYNAMISM, DYNAMIC MANAGERIAL CAPABILITIES, AND DELIBERATE ORGANIZATIONAL LEARNING ON THE SME PERFORMANCE WITH DYNAMIC CAPABILITIES AS MEDIATOR VARIABLE.
(CASE STUDY ON SMALL AND MEDIUM ENTERPRISE IN SURABAYA)**

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Abstract

Rapid change on business environment requires the business practitioner to prepare in order to stay exist and keep efficient. The company with good quality will be able to take an advantage when compete with other companies. SMEs in Indonesia influences national economic growth. SMEs have been proved as a resilience entity when face the global crisis. Also, SMEs contribute positively to the society. This study was conducted on SMEs in Surabaya to assess the effect on dynamic capabilities when faced the external environmental changes which are frequently uncontrollable and unpredictable. The research sample is 114 SMEs in Surabaya area. The data will be analyzed by structural equation modeling. The study found that environmental dynamism, dynamic managerial capabilities, and deliberate organizational learning gave a considerable effect on dynamic capability, however these variables did not prove a significant effect on firm performance. The dynamic capability variable mediated the relationship between environmental dynamism, dynamic managerial capabilities and deliberate organizational learning towards firm performance.

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Introduction:-

The economic situation nowadays become more difficult for enterprise, at the same time the competition in the market also increase significantly. This era also see the rapid technological change. The political situation and government regulations also affect the economic situation of a country. Economic slowdown, currency war, and declining commodity prices have become a common concern that must be solved immediately. Taking into account on those situation, it become a question, do companies in Indonesia ready to face those difficulties.

The facts show many companies both global and local are not able to stand the rapid changes. For instance, two global companies that once were market leader in their particular market which are Nokia and Polaroid. Both of them are dying due to rapid changes in the world. Now, the question is how do Indonesian companies deal with this situation.

Indonesia has incredible resources, both natural resources in the form of raw materials, as well as considerable human resources. High amount of natural resources in various sectors and also the number of inexpensive labor

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become a benefit in various business sectors in Indonesia. However, the Small and Medium Enterprises (SMEs) hold an important role in the economy of the country. SMEs are able to increase regional GDP as well as national one.

East Java economic growth is considering as the highest compare to the other provinces in Java. For instance DKI Jakarta economic growth only grew 6.11 percent, West Java 6.06 percent, and Central Java 5.81 percent. Even the cumulative Regional Gross Domestic Product is also higher than the national growth. The national GDP is 5.78 percent (East Java Prov, 6 February 2014).

In the previous related studies, it is shown that former success companies are now struggling to survive whereas many of them have fallen due to the rapid changes on business environment. (Harreld *et al.*, 2007).

Garengo and Bernardi (2007) in their study of 100 SMEs in Italy, said that the lack of priority on capability development within an organization became the main factors that inhibit the development of SMEs in Italy. The SMEs focused only on operational development alone, so companies do not focus on face external situations.

In order to anticipate change in situation, Dynamic Capabilities can be the solution for SMEs. It is based on Teece and Pisano' theory (1994) which stated that successful companies show rapid response, fast and flexible product innovation, along with management capabilities. All of those will effectively coordinate and manage their internal and external competences with the principles of adaptation, integrate, and reconfigure for both internal and external organizational capabilities and resources in order to address changing environment.

Based on the explanation above, this study will analyze the implementation of Dynamic Capabilities on SMEs in Surabaya since they are also facing the external environmental changes which are uncontrollable and unpredictable. The study will also assess how Dynamic Capabilities helps to maintain competitiveness in the long term.

Chang and Wang (2013) explained the competitive advantage theory in 4 stages: early period theories, exogeneous theories, endogenous theories, and dynamic capabilities theories. Dynamic Capabilities are defined as the capability of the company to integrate, build and align internal- external factors to adapt the rapid changes in environments, hence the Dynamic Capabilities are key factor to achieve sustainable competitive advantage (Teece *et al.*, 1997; Teece, 2007; Ahmed, 2007). In addition, Teece and Pisano (1994) also pointed out the importance of considering the changing nature of the external environment as well as the role of strategic management, principled on adaptation, integration and reconfiguration of internal and external organizational skills, functional resources and functional competencies to the changing environment.

In some previous studies, there were research gap in the studies which are weak effect from Dynamic Capabilities to Firm Performance (Zott, 2003; Helfat *et al.*, 2007), while others stated that Dynamic Capabilities had no direct effect to Firm Performance (Drnevich & Kriaciunas, 2011; Wu, 2010; D'Aveni *et al.*, 2010). There are also some studies that found the negative effect from Dynamic Capabilities to Firm Performance (Shreyogg & Kliesch-Eberl, 2007).

Literature Review:-

Environmental Dynamism:-

Environmental Dynamism is a rapid and unpredictable rate of external change from companies in industrial environment, such as rapid changes in technology, markets and strong competition (Dess & Beard, 1984). Jiao *et al.*, (2011) describes about four indicator to measure the level of Environmental Dynamism within a company. These indicators will indicate the frequency of changes in some areas as follows:

1. The Product/Service features desired by costumers
Measures the level of consumer demand for a pre-existing or new product or service.
2. The Product/Service features supplied by competitors
Measures the frequency of discharge and the aggressiveness of new products or services issued by competitors that will affect the level of competition in the market.
3. Product Technologies in the Industry
Measures the level of technological advances in both the product / service used

4. Government Policy in the Industry

Measures the level of policy of local and central government or frequency of rate of change in government regulations that affect company policy in achieving company performance.

Dynamic Managerial Capabilities:-

Dynamic Managerial Capabilities is defined as corporate management capability to build, integrate, configure resources, and organizational competencies in order to build a company's ability to support heterogeneity in managerial decisions and company performance as a responses of changing external conditions. (Adner & Helfat, 2003). Harrell *et al.* (2007) suggest that one main task from managerial role is to develop the company's Dynamic Managerial Capabilities.

Adner and Helfat (2003) suggested that Dynamic Managerial Capabilities can be measured by these indicators:

1. Managerial Human Capital (Castanias & Helfat, 1991, 2001).
Measures managerial skills that require investments in education, training or learning more specifically.
2. Managerial Social Capital (Burt, 1992; Gelatkanycz, Boyd & Finkelstein, 2001).
Measures capabilities which are generated by relationships or social relationships either through community memberships of hobby, social clubs as well as associations.
3. Managerial Cognition (Hambrick & Mason, 1984; Huff, 1990; Hoopes & Johnson, 2003).
Measuring ability related to the belief or mindset of management as the basis for managerial decision making.

The three elements above which are Managerial Human Capital; Managerial Social Capital and Managerial Cognition complement each other and support Dynamic Managerial Capabilities in different areas of managerial: Managerial Human Capital is required for decision making, Managerial Social Capital provides relevant and necessary information, and Managerial Cognition provides support in action taken.

Deliberate Organizational Learning:-

Deliberate Organizational Learning is an ability from the organization to keep learning and develop its capabilities through an orderly, structured, and consistent pattern through a series of systematic routine activities within an organization in order to pursue the effectiveness of the work (Zollo & Winter, 2003). Learning is an important component of Dynamic Capabilities. This consists of two aspects: organizational engagement and human resources, also routine activities that provides the right solutions to organizational problems. Besides that, there are also three elements in the process of deliberate organizational learning (Zollo & Winter, 2002):

1. Experience Accumulation
It is an accumulation of experience from everyday events in an organization.
2. Knowledge Articulation
It is a process where implicit knowledge is articulated through collective discussions, de-briefing sessions, and performance evaluation processes.
3. Knowledge Codification
It is an understanding of codification obtained from routine operational activities as well as new things.

Dynamic Capabilities:-

Dynamic Capabilities is the capability of a company to integrate, build, and align internal and external factors to adapt the rapid changes of environment (Teece *et al.*, 1997). Eisenhardt and Martin (2000) said that dynamic capabilities can also be applied in the moderate change situations. Hence, it can be concluded that dynamic capabilities can be implemented in various dynamic levels of the external environment.

There are three indicators that explain the organizational mechanisms to connect the advantages of internal resources into the external environment:

1. Adaptive Capability
It is an ability to read opportunities in the external market and then manage those opportunities with quick and precise responses in the company's strategy. For example, marketing activities that are able to adapt to changing market conditions (Milles & Snow, 1978; Chakravarthy, 1982; Hooley *et al.*, 1992).
2. Absorptive Capability
Absorptive Capability is the company's ability to recognize the value of new external information, then adopt it to the commercial outcomes. This also includes the ability to evaluate and leverage outside knowledge into the level of knowledge required by an organization (Cohen & Levinthal, 1990).

3. Innovative Capability

It can be defined as the company's ability to develop new products or to enter new markets, through alignment or adjustment on strategic innovation which is backed by actions or organizational behavior through innovative processes (Wang & Ahmed, 2004).

Firm Performance:-

Performance appraisal is a periodic determination of operational effectiveness of an organization, as a part of the organization and human resources management (Mulyadi, 2007). Company performance is an accumulation of the results of activities which is undertaken by the company. In addition, performance can be defined as the success of the company in five dimensions from The Dynamic Multi-Dimensional Performance Model as follows:

1. Financial Performance
It is the management's perception of current profit trend over the previous year.
2. Market/costumer
It is a management perception of customer satisfaction and loyalty.
3. Process Measures
It is a management perception of the production process, product quality, and also employee motivation.
4. People Development
A perception of employee development, motivation management, and career path.
5. Preparing for the Future
The management perception of upcoming market trends and the readiness of strategy and investment to deal with that.

Research Method:-

This research is explanatory research which will prove the causal relationship between the independent variable Environmental Dynamism (ED); Dynamic Managerial Capabilities (DMC); Deliberate Organizational Learning (DOL) to Firm Performance (FP) with Dynamic Capabilities (DC) as intervening variable.

Conceptual frameworks and hypotheses are based on related theories that Environmental Dynamism, Dynamic Capabilities, and Firm Performance are interconnected each other (Eisenhardt & Martin, 2000; Winter, 2003; Sirmon & Hitt, 2003; Zahra *et al.*, 2006; Schreyogg and Kliesch-eberl, 2007; D 'Aveni *et al.*, 2010). Dynamic Managerial Capabilities, Dynamic Capabilities, Firm Performance are also theoretically interconnected (Gahasyzc and Hambrick, 1997; Adner and Helfat; 2003; Eisenhardt and Martin; 2000; Helfat *et al.*, 2007; Aragon-Corea and Sharma, 2003; Cepeda and Vera, 2007). While the relations between Deliberate Organizational Learning, Dynamic Capabilities, and Firm Performance are based on Zollo and Winter (2002); Zott (2003); and Chien and Tsai (2012). Here is the conceptual framework and the hypothesis.

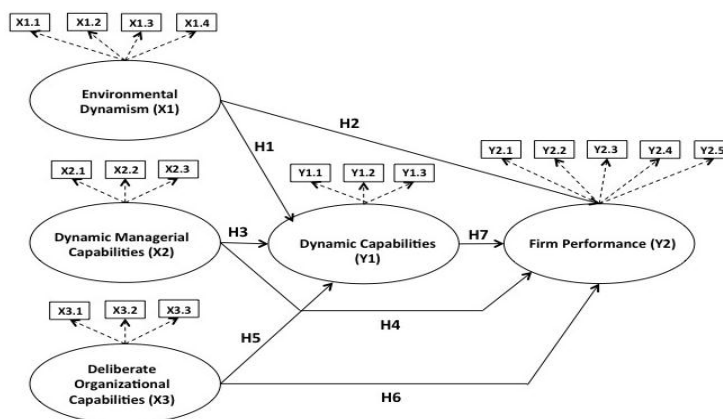


Figure 1:- Research Framework

- H1 : Environmental Dynamism has significant effect on Dynamic Capability SMEs in Surabaya.
- H2 : Environmental Dynamism has a significant effect on SME Firm Performance in Surabaya.
- H3 : Dynamic Managerial Capability has a significant effect on SME Dynamic Capabilities in Surabaya.
- H4 : Dynamic Managerial Capability has a significant effect on SME Firm Performance in Surabaya

- H5 : Deliberate Organizational Learning has significant effect on Dynamic Capabilities SMEs in Surabaya
 H6 : Deliberate Organizational Learning has a significant effect on SME Firm Performance in Surabaya
 H7 : Dynamic Capabilities has a significant effect on SME Firm Performance in Surabaya

The population in this study is SMEs which work on manufacturing sector in Surabaya. The sampling technique is Proportional Stratified Random Sampling which get 114 manufacturing SMEs in Surabaya. The indicator of the Environmental Dynamism variable is based on Jiao *et al.*, (2011) research which are consisting of 4 indicators: the product/service features desired by costumers, the product/service features provided by competitors, product technologies in industry, and government policy in the industry. Dynamic Managerial Capability is measured based on research by Adner and Helfat (2003). The variable consists of 3 indicators: managerial human capital, managerial social capital, managerial cognition. Deliberate Organizational Learning's indicators are based on Zollo & Winter (2003) which are experience accumulation, knowledge articulation, and knowledge codification. Dynamic Capabilities is measured according to Wang and Ahmed (2007) which consists of adaptive capability, absorptive capability and innovative capability.

The Firm Performance is measured according to Mulyadi's research (2007). The performance is measured by financial performance, market and costumers, process measures, people development, and preparing for the future. All research hypotheses are analyzed by Structural Equational Modeling analysis technique with AMOS 20.0 software.

Result And Discussion:-

The research population is SMEs which have established more than 5 years and have employees around 5-10 people. The pre-test procedure in order to check the questionnaire has been done and shown that all of the questions are appropriate.

Confirmatory factor analysis on each variables concluded that the convergent valid condition is fulfilled. It can be concluded from loading factor and average variance extracted are higher than 0.50. Also, the model has met construct reliability as it shown value higher than 0.70, for further detail, please refer to table 1

Table 1:- Results of *Confirmatory Factor Analysis*

Indicator	FL	FL ²	Error	Construct Reliability	Average Variance Extracted
X1.1 --> X1	0,843	0,711	0,289	0,904	0,701
X1.2 --> X1	0,878	0,771	0,229		
X1.3 --> X1	0,794	0,630	0,370		
X1.4 --> X1	0,833	0,694	0,306		
X2.1 --> X2	0,872	0,760	0,240	0,877	0,705
X2.2 --> X2	0,891	0,794	0,206		
X2.3 --> X2	0,748	0,560	0,440		
X3.1 --> X3	0,825	0,681	0,319	0,895	0,740
X3.2 --> X3	0,888	0,789	0,211		
X3.3 --> X3	0,867	0,752	0,248		
Y1.1 --> Y1	0,824	0,679	0,321	0,905	0,761
Y1.2 --> Y1	0,936	0,876	0,124		
Y1.3 --> Y1	0,854	0,729	0,271		
Y2.1 --> Y2	0,993	0,986	0,014	0,839	0,756
Y2.2 --> Y2	0,623	0,388	0,612		
Y2.3 --> Y2	0,689	0,475	0,525		
Y2.4 --> Y2	0,550	0,303	0,698		
Y2.5 --> Y2	0,673	0,453	0,547		

The result from full SEM model has found that the model fulfilled *univariate* and *multivariate normality* assumption (cr kurtosis, cr skewness, cr *multivariate* are in the range of ± 2.58). The research data was concluded not containing

univariate outlier with Z Score ± 3.0 and multivariate outlier with mahalanobis d squared < chi square table. Estimation results from the structural model of SEM at figure 2:

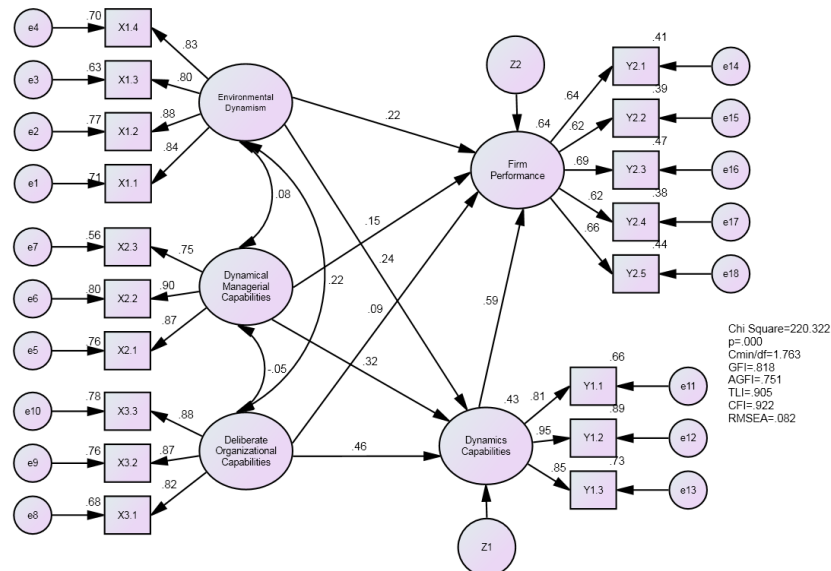


Figure 2:- Full Model

Full model estimation shows the violation of goodness of fit tests hence the model need to be modified, as in Table 2:

Table 2:- Goodness Of Fit Full Model

Goodness of Fit Index	Cut off Value	Results of Model	Description
Chi-Square	< 152,094	220,322	Unfit
Probability Chi-Square	> 0,05	0,000	Unfit
CMIN/DF	≤ 2,0	1,763	Fit
GFI	≥ 0,90	0,818	Unfit
AGFI	≥ 0,90	0,751	Unfit
CFI	≥ 0,95	0,905	Unfit
TLI	≥ 0,95	0,922	Unfit
RMSEA	≤ 0,08	0,082	Unfit

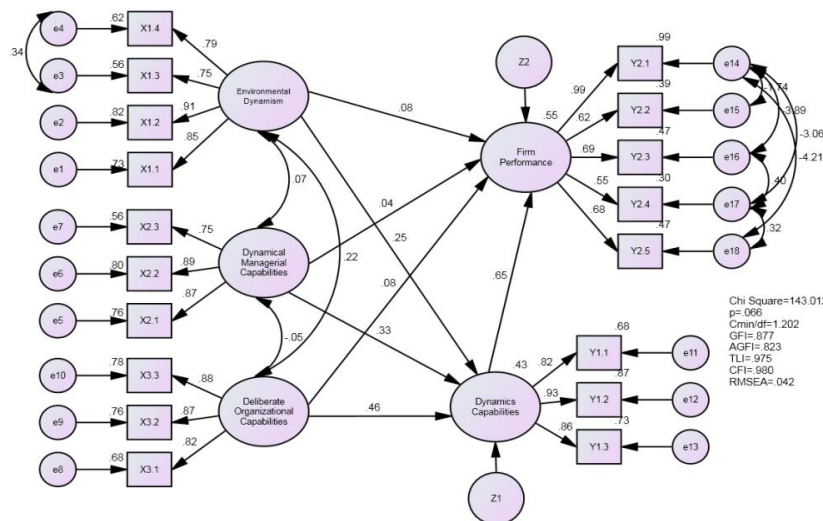


Figure 3:- Full Model Modification

The estimation result of *full model modification* shows the *goodness of fit* criteria have been achieved. In addition, the model can be used for hypothesis testing, as shown in Table 3 below.

Table 3:- Goodness Of Fit Full Model Modification

Goodness of Fit Index	Cut off Value	Results of Model	Description
Chi-Square	< 145,461	143,012	Fit
Probability Chi-Square	> 0,05	0,066	Fit
CMIN/DF	≤ 2,0	1,202	Fit
GFI	≥ 0,90	0,877	Marginal
AGFI	≥ 0,90	0,823	Marginal
CFI	≥ 0,95	0,975	Fit
TLI	≥ 0,95	0,980	Fit
RMSEA	≤ 0,08	0,042	Fit

Hypothesis testing based on the results in *full model modification* listed in Table 4 as follows.

Table 4:- Hypothesis Testing

Line of Influence	Great Influence	CR	p
ED → DC	0,245	2,766	0,006
ED → FP	0,078	1,231	0,218
DMC → DC	0,328	3,743	<0,001
DMC → FP	0,044	0,630	0,529
DOL → DC	0,464	4,829	<0,001
DOL → FP	0,083	1,122	0,262
DC → FP	0,649	6,753	<0,001

Hypothesis of Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC) and Deliberate Organizational Learning (DOL) toward Dynamic Capabilities (DC) summed up all of them significantly ($p = 0.006$ and <0.001). The influence of Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC) and Deliberate Organizational Learning (DOL) toward Dynamic Capabilities (DC) are all positive by 0.245; 0.328; And 0,464 which means they are able to increase the Dynamic Capabilities from SMEs in Surabaya. The effect from Dynamic Capabilities (DC) to Firm Performance (FP) also has significant influence ($p = <0.001$). The effect from Dynamic Capabilities is 0.649 which means it can improve the Firm Performance of SMEs in Surabaya.

On the other hand, Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC), and Deliberate Organizational Learning (DOL) do not give significant direct effect on Firm Performance (FC) ($p = 0,218$; 0,529 and 0,262). Based on these, there is only an indirect influence from Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC) and Deliberate Organizational Learning (DOL) to Firm Performance (FC) through Dynamic Capabilities (DC) which is full mediation with high influence on 0.159; 0.213; And 0.301.

Effect of Environmental Dynamism on Dynamic Capabilities: -

The result shows there is an influence from Environmental Dynamism toward the Dynamic Capability of SMEs in Surabaya. The result is similar with Eisenhardt and Martin (2000); Winter (2003) and Hitt (2003) which state that Dynamic Environments provide enormous changes in Dynamic Capabilities. The existence of Dynamic Environmental factors push the company to have a good ability in developing Dynamic Capabilities, so the company can maintain better performance.

Effect of Environmental Dynamism on Firm Performance: -

The analysis shows there is no influence from environmental dynamism to firm performance of SMEs in Surabaya. This result is not align with Hitt (2003) who states that environments will influence the Dynamic Capabilities of the company.

Effect of Dynamic Managerial Capabilities on Dynamic Capabilities: -

The result mentioned an influence between Dynamic Managerial Capabilities with Dynamic Capabilities of SMEs in Surabaya. This finding is similar with Harreld et al. (2007); Castanias and Helfat (2001); Cepeda and Vera (2007) who suggest that one aspect of the core managerial role is to develop the Dynamic Capabilities in the company. This

finding support the idea if the managerial role is better then the role in developing Dynamic Capabilities will also be better.

Effect of Dynamic Managerial Capabilities on Firm Performance: -

The finding shows no influence from Dynamic Managerial Capabilities to Firm Performance of SMEs in Surabaya. This is not in accordance with Harreld et al. (2007). This means if managerial roles cannot support the process of developing the company's Dynamic Capabilities, then it will hamper the development of SMEs.

Effect of Deliberate Organizational Learning on Dynamic Capabilities: -

The result mentioned there is an influence from Deliberate Organizational Learning toward the Dynamic Capabilities of SMEs in Surabaya. This statement align with the research from Zollo & Winter (2002). Dynamic Capabilities are derived from the result of the semi-automatic learning mechanism in a certain period of time. The learning process of the company can be done by sharing knowledge with other companies so the positive input can be obtained to improve the company in the future (Zollo & Winter, 2002).

Effect of Deliberate Organizational Learning on Firm Performance: -

The result stated there is no influence between Deliberate Organizational Learning towards Firm Performance of SMEs of Surabaya. This is different with Reswanda' research (2012) which suggests that the creative thinking process and innovative starting from the discovery of ideas which followed by the ability to form process systems such as ideas, methods and ways to produce unique products and services. Also, this generate added value on something new or product / service development.

Effect of Dynamic Capabilities on Firm Performance: -

The findings stated there is influence from *Dynamic Capabilities* to Firm Performance of SMEs in Surabaya. The result is similar with findings from Chien and Tsai (2012) who concluded that *knowledge* based on Dynamic Capabilities can improve company performance, however knowledge resources and learning mechanism have been proven to improve the development of Dynamic Capabilities. Increasing knowledge and ability of a company in developing work system and product will improve performance of the company. This happen due to the knowledge is gained largely by interactions with other companies, so that it can help the company to adopt it for future plans.

Conclusion:-

The research has concluded that Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC) and Deliberate Organizational Learning (DOL) has a significant direct influence toward Dynamic Capabilities (DC). In addition, Dynamic Capabilities (DC) has direct influence to firm performance. Other conclusions mentioned that there is no significant direct influence between Environmental Dynamism (ED), Dynamic Managerial Capabilities (DMC), and Deliberate Organizational Learning (DOL) to Firms Performance (FC). Instead of direct effect, these variables have indirect effect through Dynamic Capabilities with full mediation.

Establishing good relationships with government and other SMEs can be improved to gain important information on rapid environmental changes. In addition, such a relationship can increase the knowledge of SMEs owners on government policies that can improve the performance of the SMEs.

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