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The Effect of Innovation Strategy on Financial Performance Small and Medium Enterprises in Indonesia

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ABSTRACT

The free market in Southeast Asia region since 2016 caused Indonesian business competition is getting strict. Innovation as a very important strategy that must be implemented by the company to create superior products in the business competition. Competitive advantage with the right business strategy can improve financial performance. Product innovation and process innovation as a strategic choice are implemented to improve financial performance. This paper analyzes the effect of product innovation and process innovation on financial performance. The data were collected by distributing questionnaires to 26 owners/managers of ceramic small and medium enterprises in Malang, Indonesia. Regression analysis has been used to test the proposed hypotheses. The findings showed that product innovation is more frequent to implemented as a business strategy by ceramic small and medium enterprises in Malang, Indonesia. Furthermore, the innovation strategies give significant effect on financial performance of ceramic small and medium enterprises in Malang, Indonesia.

Keywords: Product innovation; Process innovation; Financial performance; SME.

1. INTRODUCTION

Small and Medium Enterprises (SMEs) is one form of business units that exist in Indonesia. This business is managed by individuals, families and communities, and has resistance on the economic crisis. Increasing competition in era of the Asean Economic Community (AEC) is not only for big companies, but SMEs must restore to improve its performance by improve its ability. Strategies to hold up in the intense competition, SMEs must improve the creativity that realized in the innovation strategy to produce products that have a competitive advantage. Innovation is defined as the implementation of significant

improvement of products, processes, new marketing methods and new organizational method in business practices, workplace organization or external relations (The Organisation For Economic Co-Operation And Development/OECD, 2005). Innovation is a key success and survival factor of the company (Cho and Pucik, 2005). Innovation is also a major factor to gain a sustainable superior competitive in the marketplace. The importance of innovation is also expressed by Gaynor (2002), innovation improve the growth of the organization, controlling the success on future, and as a driver of business to hold up the viability of the organization in the global economy. In the free market, business competition is getting strict. All businesses which work on both product and services businesses vying with each other to be the best in order to win consumers in the free market and increasingly fierce business competition. Then, every day new competitors with new business models and products continue to emerge. Therefore, employers should be able to respond and innovate so that the business has a competitive advantage and have strong competitiveness. Innovation that produces high value and sustains will be decisive in order to enter the market and become a market leader. Moreover, innovation implemented as a new way to come out of boredom of a product, so the consumers have many options to use practical products that are based on their needed. Furthermore, consumers are willing to pay a higher price for an innovation.

The reality show that most SMEs have implemented innovation. This is consistent with the statement of the researchers that innovation is more often carried out by SMEs than large companies (Afuah, 1988). SMEs as business entities are in a dynamic environment that the innovation is already a must. Innovation is a major aspect that leads to competitive advantage. Innovation is a breakthrough step to be able to create something new that does not implement by a person or institution and can give effect to changes in higher performance. Griffin (2006) describes the form of innovation that may occur on SMEs, include: a radical innovation of products, services or new technologies developed by an organization that completely replaces the products, services or technologies; a gradual innovation of products, services or new technologies that modify the products, services or technologies; Technical innovation is a change in physical appearance or performance of a product or service, or a physical process in which a product or service is made; product innovation is a change in the characteristics or the performance of existing products or services or the creation of a product or service that is entirely new, the innovation process is a change in the way products and services are made, created, distributed.

Then, OECD (2005) describes the product innovation, innovation of process and marketing innovation. Product innovation is the introduction of new goods and services that is developed significantly with respect to the characteristics or uses of goods or services; innovation of process is the implementation of the method of production and delivery that is new or significantly improved, which includes significant changes in techniques, equipment and/or software; marketing innovation is the implementation of new marketing methods that include significant changes in product design or packaging, product placement, product promotion or pricing. Bessant and Tidd, (2007) defines product innovation as the changes in the form of products/services offered by an organization. In this research, product innovation is defined as the development and changes in the characteristics that can increase the value of products/services designed to meet the needs of consumers. Furthermore, Francis and Bessant (2005) defines process innovation as a changes in the way products or services are created and delivered. Another definition states that process innovation illustrates the change in the way organizations produce final products and services from a company (Cooper, 1998). In this research process innovation is defined as the implementation of changes in the way organizations create products and deliver services.

In general, the establishment of a business purpose. Achrol and Etzel (2003) states that the level of interest achievement illustrates the company's performance. Another definition states that the company's performance is the results achieved in meeting the objectives of internal and external company (Lin Peng, Ching Kao, 2008). The company's performance can be measured by financial and non-financial measures (Darroch, 2002). The majority of companies prefer to use financial indicators to measure performance. Kargar and Parnell (1996) argues financial indicators are not the only measure of corporate performance. Non-financial indicators needed to adjust to change firm internal and firm external environment. Innovation is the important key to make company success when competing in the market. The synergy of the different types of innovations in the management activities of an SME must be carried out to improve business performance. Several previous studies have examined the relationship of innovation with performance. Han, Kim, Srivastava (1998) stated that the innovation and performance of the company has a positive relationship; Salavou (2002) states that the product innovations is a significant determinant of business performance based on the return on assets; Marsili and Salter in Neira, Lindman and Fernandez (2008) states that the product innovation, process innovation and marketing innovation affects the ability to make profit in different ways. This means higher profits depend on the implemented level and/or types of changes. Najib and Kiminami (2011) states there is a significant correlation between innovation (product innovation and process innovation) and business performance of the company, meaning that using innovative practices will produce competitive advantage and drive better business performance.

Neira, *et. al*, (2008), Murat and Birdogan (2011) states that the product innovation and process innovation undertaken in SMEs can improve financial performance. Then Camisón and Ana (2010) stated that the production flexibility supposed to develop innovation ability to gain increased organizational performance. If the production flexibility helps improve the performance of the company, managers should be able to use this flexibility to generate the organization's ability based on product innovation, process innovation and organizational innovation which will create a competitive advantage. The findings were supported by Murat Atalay, Anafarta, Sarvan, (2013) stated that technological innovation (product innovation and process innovation) needed to strengthen the competitiveness of SMEs when facing increasingly fierce competition. Based on some earlier research, the kind of innovation that is relevant for further research on SMEs include product innovation and process innovation. Both types of these innovations have been tested in several studies that show the relationship with financial performance in the small and medium enterprises.

The results of some previous studies on the relationship between innovation and financial performance, namely: Bhattacharya and Harry (2002) suggested the higher performance of business profitability the higher of innovation level in low technology; Huang and Chun (2005) stated that innovation capital affects performance; Pinayides (2006) suggests the stronger relationship orientation will make the level of innovation is higher and improve corporate performance, Salavou and George (2008) states stright innovation and product innovation as the mediation of the relationship between innovation and corporate performance; Neira, *et. al*, (2009) suggested the higher increase in the product innovation and process innovation, the higher business performance achieved. Likewise, Ar and Birdogan (2011) suggested the higher increase in the product innovation and process innovation, the higher business performance achieved; Najib and Akira (2011) stated that innovation (products and processes) as a mediating variable in the company's internal cooperation, cooperation with the government, cooperation with research institutes and business performance (as measured by sales volume, profitability and market share); Rahab (2012) suggested learning

orientation strengthen the influence of market orientation towards innovation, Atalay *et. al*, (2013) states the higher level of product innovation and process innovation will improve the achievement of the company's performance, Rosli and Syamsuriana (2013) argued product innovation and innovation of process has an impact on the performance of companies.

The role of innovation from the perspective of human resource management emphasizes the importance of production factors such as labor to develop and produce products or services that have high competitiveness, so we need a further study to analyze the impact of product innovation and process innovation to the financial performance on ceramics SMEs in Malang, Indonesia. Innovation strategies referred to in this research is a business strategy to product innovation and innovation of process. Product innovation and process innovation is measured by item indicator. The financial performance of the company is the achievement of organizations working performance which shows the company's financial development, and is measured by the level of production, marketing, and business profit growth.

Motivated from previous studies, with testing the developed conceptual model following a review of theory and empirical studies, namely the relationship between innovation (products and processes) and financial performance, this paper analyzes the effect of product innovation and process innovation on financial performance. The study was conducted at a ceramic craft SMEs that the location is in Malang, Indonesia. The products produced in these SMEs in the form of accessories and housewares from ceramics (such as cups and jars). The products obtained are, if it is associated with the development of creativity will produce innovative works that are relevant to changing consumer demand. The more variety of products produced from these SMEs, competitiveness position becomes stronger. SMEs that have high competitiveness will increase turnover and profits.

The rest of this paper is organized as follow: Section 2 describes rudimentary. Section 3 presents our proposed method. Section 4 gives obtained results and following by discussion. Finally, section 5 concludes this work.

2. RUDIMENTARY

2.1. Innovation

Schumpeter (1934) defines innovation is creating new combinations on the introduction of new goods, the quality of new stuff or new production methods, open up new markets, the conquest of a new source for suppliers of raw materials or semi-finished goods, and eventually led to a new organization in a industry. Then, Urabe, Child and Kagono (1988) define innovation as the generation of a new idea and implemented into new products, processes or services, which resulted in the dynamics of national economic growth and boosting employment and making profit for companies that innovate in the field of business. Development of new ideas into products, processes or services may increase the company's market share, and lead to better performance. Innovation can implement on the goods, services or ideas received by a person as something new, so that might be an idea has emerged in the past, but can be considered innovative for consumers that knew just now.

Rogers (2003) defines innovation as an idea, practice or object/thing that is recognized and accepted as a novelty by a person or group to be adopted. Law of the Republic of Indonesia Number 18 Year 2002 states innovation is a research, development, engineering which aims to develop practical value and context

of the application of new knowledge, or new ways to apply science and technology that has existed in the product process or production. Innovation diffused to the entire community in a predictable pattern. Two kinds of innovations that are used as an indicator in this study, namely product innovation and process innovation. Corporate which effectively implement innovation can easily make profit. There is a fairly strong correlation between innovation and financial performance. Neira, Lindman and Fernandez (2009) states that the rate of innovation has significant positive effect on financial performance, where the differences in performance levels associated with the type of innovation developed.

2.2. Product Innovation

Galbraith (1973) and Schon (1967) defines product innovation as a process of the use of new technology into a product so that the product has added value. Then Crawford & De Benedetto (2000) defines product innovation is an innovation that is used in the overall operation of the company where a new product is created and marketed, including innovation in all functional processes/usefulness. OECD (2005) defines product innovation is the introduction of new goods and services or developed significantly with respect to the characteristics or usage of each. These innovations include significant improvements in technical specifications, components and materials, incorporated software, user friendliness or other functional characteristics. Product innovation using knowledge and new technologies, or based on new uses or combinations of existing knowledge and technology. This study defines the product innovation as a business carried by the company to create new products that aim to adapt to consumer tastes and can increase sales. Based on the definition of product innovation above it can be concluded that the definition of product innovation is: A business carried by the company to create new products that aim to adapt to consumer tastes and can increase sales. Thus it can be said that the increasing number of goods offered to consumers and supported by the flow of information about the products that are easy to obtain, causing them become more selective in buying an item, either in quality, design style, color and price.

2.3. Process Innovation

Process innovation is defined as the implementation of the method of production and delivery that is new or significantly improved. Francis and Bessant (2005) defines process innovation as a changes in the way products or services are created and delivered. According John (1999) process innovation provides a means to maintain and improve the quality and to save costs. Process innovation aimed at reducing costs of production and delivery, to increase quality or to produce or deliver new or significantly improved product. The production method includes engineering, equipment and software used to produce goods or services. The logistic delivery method of company includes equipment, software and technical input source, inventory allocation within the enterprise, or deliver the finished product. Process innovation is a new element introduced in the company's products and services operation, such as raw material, from job specifications, mechanisms, and equipment used to manufacture products or provide services. John (1999), process innovation provides a means to maintain and improve the quality and to save costs. Francis and Bessant (2005) defines innovation as a process of changes in the way products or services are created and delivered. Another definition states that the process innovation illustrates the change in the way organizations produce finished products and services from a company (Cooper, 1998). In this research innovation of process is defined as the implementation of changes in the way organizations create products and deliver services.

2.4. Financial Performance

Financial performance is an overview of the achievements of the company, which can be interpreted as the results achieved on the various activities that have been carried out. Then, Lin *et. al*, (2008) reported financial performance is the result of the organization's operations, include achieving the internal and external objectives. Fahmi (2012) states that financial performance is an analysis done to see the extent of whether a company has conducted with using the rules of financial performance well and right. Financial performance as measure - a certain measure that can measure the success of an organization or company in generating profits. Meanwhile, according to the Indonesian Accountants Association (2007), the financial performance is the company's ability to manage and control its resources.

Understanding company's financial performance is quite closely related to the assessment of the health level of a company. So, the better the company's performance, the better the health of the company. The financial performance is the periodically determination of operational effectiveness of an organization and its employees based on the objectives, standards and criteria that is established in advance ". Financial performance is a condition that reflects a company's financial situation based on your goals, standards and criteria established. From some understanding of the financial performance from the above, it can be concluded that financial performance is the achievement of the company in a period which describes the condition of the company's financial health indicators of capital adequacy, liquidity and profitability.

Financial performance assessment is one way that can be done by the management in order to meet its obligations to funders and also to achieve the goals set by the company. Financial performance is an indicator of good or poor management decisions in decision-making. Management can interact with internal and external environment through information. The information further stated or summarized in the financial statements. Camisón (2005) measures the performance of small and medium enterprises with reference to the three aspects, namely profitability, productivity, and market, while Lee and Tsang (2001) measure the performance of businesses with venture growth consisting of sales growth, the growth of the company's assets and the growth of business profit. Studies of small and medium enterprises business performance measurements typically use a mixed approach (financial and non-financial). However, difficulties arise when menajer or owners of small and medium enterprises are unwilling or mind giving financial performance data information. The majority of SMEs are not willing or mind giving financial performance data. Lee and Tsang (2001) suggests the real conditions in small and medium enterprises showed the unavailability of records that meet the accounting standards, therefore performance is measured using the perception of the owner or manager based on performance measures which consist of sales growth, asset growth, and business profit growth. Therefore, it is possible to use the perception approach the owner or manager (Dess and Robinson, 1984).

The real conditions in Ceramics SMEs in Malang-Indonesia showed that there are no financial statements, so this study measure the financial performance using perception of the owner or a manager based on the sales growth, asset growth, and growth in profits. Then, reality shows that the majority of SMEs in the form of sole proprietorship still develop production and expand the area of marketing and profit-oriented growth, so that the financial performance in this study is measured by the level of production, marketing and profit growth.

Based on the study of theory and previous research studies, the link between innovation and financial performance realized in the form of the conceptual framework research (Figure 1). So the research make hypothesis as follows:

H1: The higher product innovation will improve the financial performance of Ceramics Crafts Small and Medium Enterprises in Malang, Indonesia

H2: The higher process innovation will improve the financial performance of Ceramics Crafts Small and Medium Enterprises in Malang, Indonesia.

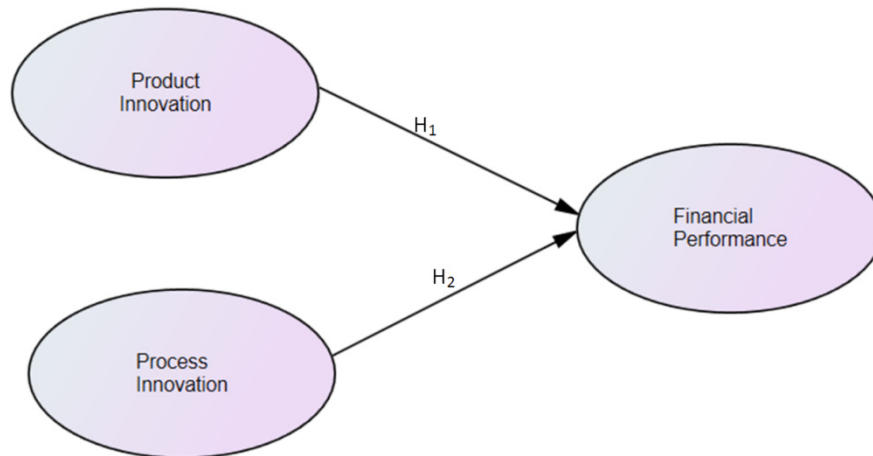


Figure 1: Conceptual framework research

3. PROPOSED METHOD

The object of this research is Ceramics Craft SMEs that location is in Malang, Indonesia. The population of this study are all Ceramics Craft entrepreneurs are included in the category of Ceramics Craft SMEs in Malang, Indonesia. Number of Ceramics Craft SMEs in Malang-Indonesia as many as 26 SMEs. This study uses a technique nonprobability sampling that means a sampling technique that does not give opportunity/equal opportunity for each element or member of the population to be selected as a sample. Further sampling use saturation sampling is sampling technique when all members of the population used as a sample. This is done because the population is relatively small, less than 30, so it is necessary to take all the samples in members of the population.

The data used is primary data, i.e data about innovation and financial performance obtained directly from respondents who serves as the owner or manager of Crafts Ceramics Small and Medium Enterprises in Malang, Indonesia. The technique of collecting data is using questionnaires, in the form of open questions covering the identity of the respondent and closed questions with alternative answers that respondents lived choose one of the alternative answers (Hair, 2010). Data measurement techniques using a Likert scale has five levels: 1 = strongly disagree, 2 = disagree, 3 = quite agree, 4 = agree, 5 = strongly agree. In using of Likert scale, the variables are translated into the indicator variables. Then, the indicator is used as a starting point to create items instrument that are statements.

Instrument test is used to test instrument item or question of each indicator. Instruments test is necessary to test the validity and reliability of each questions. Validity is a measure which indicates that the measured variable is really variable to be investigated by researchers. Validity relates to a variable measure what should be measured. The validity of the study states the degree of precision of the measuring instrument research on the actual content being measured. Validity test is a test that is used to indicate the extent of measuring instruments used in a measuring what is being measured. Hair (2010) states that the test used

to measure the validity of a legitimate or valid whether or not a questionnaire. A questionnaire considered valid if the questions in the questionnaire were able to reveal something that will be measured by the questionnaire. Item indicator is valid if the calculated value of the product moment correlation coefficient (r_{xy}) is greater than the value of the coefficient table (r_{table}).

Reliability refers to an understanding that the instrument used in the research to obtain reliable information used as a means of collecting data and is able to reveal the actual information field. Hair (2010) states that reliability is a tool to measure a questionnaire which is an indicator of the variables or constructs. A questionnaire said to be reliable or reliable if someone answers the statement is consistent or stable over time. The reliability of a test refers to the degree of stability, consistency, predictability, and accuracy. Measurements have high reliability is a measurement that can produce reliable data. Item indicator called reliable if the Cronbach Alpha value is greater than the value of the table (r_{table}).

Methods of data analysis are using descriptive statistics, relating to the collection and presentation of a range of data so as to provide useful information that includes the company's data and description of the study variables. Hypothesis testing using simple regression. Structural equation:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + e,$$

where, β_0 , β_1 and β_2 = regression coefficient,

X_1 = product innovation,

X_2 = process innovation,

Y = financial performance, and

e = a disturbing factor.

The research variables that is used in this study consisted of three variables, namely: product innovation and process innovation as independent variables and financial performance as the dependent variable. Innovation relates to the ability of an entrepreneur who has a sensitivity to capture the opportunities that exist in the dynamics of industrial environments. Product innovation as a process of adopting a new technology into a product so that the product has added value. Innovation is defined as the process of implementation of the method of production and delivery of a new or significantly improved. The financial performance is the result of work achieved by the parties management companies within a particular period as seen from the financial statements.

4. RESULTS AND DISCUSSION

4.1. Descriptive Analysis

The education level of respondents in the Ceramics Craft SMEs nearly 52% are senior high school. It explains in conducting business manager prioritizes production experience, compared to formal education. So the ability of creativity and innovation of the product produced is influenced by experience. Respondents had been managing the business for more than 15 years, it means that the time to manage the businesses owned by the owners is high, so that the process control production activity can be done by the owner himself. The initial capital is used as working capital for the ceramic artisans business, as 64% of respondents used his own capital. This is because they don't have financial statements that meet the standards of financial

accounting, so it is still difficult to gain the trust of a bank or other financial institution. The number of workers on average are 3 to 5 people. The level of efficiency achieved from the production process on average is 1.6, it can be said that ceramics craft SMEs have fairly efficient business management. From the amount of income earned by ceramics craft SMEs are good enough, because the levels of average net income per month is quite large with a fairly high level of effectiveness. Prospects for the future of ceramics craft SMEs good enough to give hope, because this will be a place of business ceramic crafts center, and as one of tourist destination in the city of Malang, Indonesia.

4.2. Validity and Reliability

Instrument test is necessary to test the validity and reliability of item indicators. Validity test is used to test the accuracy of measuring devices. Testing the validity is done using the formula product moment correlation (r_{xy}). The measuring instrument is said to be valid when the correlation coefficient value (r_{xy}) is greater than the table value (r_{table}). This study has the number of respondents ($n = 26$) with a significance level of 5%, and found r_{table} value = 0.388, which item status indicators valid if $r_{xy} > r_{table}$, and item indicators are not valid if $r_{xy} < r_{table}$.

Prior to the test the validity and reliability, operational variables are showed in Table 1.

Table 1
Operational variables

<i>Variable</i>	<i>Item Indicators</i>
Product	Ceramic products produced variously (X11)
Innovation (X1)	Ceramic products produced have the advantage of other similar products (X12)
	Ceramic products that are produced are not out of dated (X13)
	Ceramic products found in many other places (X14)
Process Innovation (X2)	The process of making ceramics using new methods to improve the quality of the product (X21)
	The process of making ceramics by increasing complementary activities to speed up the production process (X22)
	The process of making ceramics by considering cost and time savings (X23)
	Using new method for improved ceramics delivery to the consumer (X24)
Financial Performance (Y)	Increasing production for the last 2 years (Y11)
	Increasing marketing for the last 2 years (Y12)
	Increasing profit for last the 2 years (Y13)

The validity of the test results can be seen in the following table.

Table 2
Test the validity of product innovation indicators item (X1)

<i>Item Indicators</i>	r_{xy}	r_{table}	<i>Notes</i>
X ₁₁	0.461	3.388	Valid
X ₁₂	0.422	3.388	Valid
X ₁₃	0.398	3.388	Valid
X ₁₄	0.150	3.388	Not Valid

Table 3
Validity test of process innovation item indicators (X2)

Item Indicators	r_{xy}	r_{table}	Notes
X ₂₁	0.483	3.388	Valid
X ₂₂	0.607	3.388	Valid
X ₂₃	0.654	3.388	Valid
X ₂₄	0.627	3.388	Valid

Table 4
Validity test of financial performance item indicators (Y)

Item Indicators	r_{xy}	r_{table}	Notes
Y ₁₁	0.700	3.388	Valid
Y ₁₂	0.484	3.388	Valid
Y ₁₃	0.604	3.388	Valid

Table 2 shows that the fourth item indicator X14 (produced ceramic products found in many other places) as the item indicator shows that the status of product innovation is not valid, therefore fourth item indicator is excluded from subsequent data analysis. Reliability test is used to test the reliability of measuring instrument to be able to be used again for the same research. Reliability testing in this research is done by using Cronbach Alpha formula. The measuring tool is said to be reliable if all variables have value above Cronbach Alpha coefficients. This study has the number of respondents ($n = 26$) with a significance level of 5%, which found r_{table} value = 0.388, and the value of Cronbach Alpha of 0.745. Then both value is compared, r_{table} value with Cronbach Alpha value. The result is Alpha Cronbach value $> r_{table}$, it means that the items can be said as reliable indicator or reliable as a means of collecting research data.

4.3. Hypothesis Testing

The results of the model test of the relationship between innovation and financial performance indicators along with the item, shown in Figure 2.

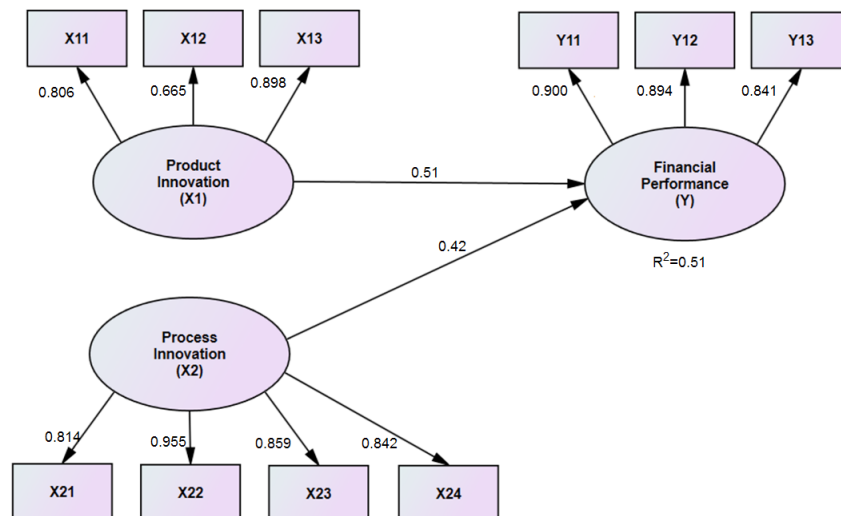


Figure 2: Test models of the relationship between product innovation, process innovation and financial performance

Figure 2 shows the results of cross loading item indicators for each variable. Item indicator of product innovation, the X11 (ceramic products produced variously) is 0.806, X12 (ceramic products produced have the advantage of other similar products) is 0.665, and X13 (ceramic products that are produced are not out of dated) is 0.898. Item X13 is the greatest indicator, meaning that the product innovation and new ceramic products are always following the taste of consumers (up to date). Item indicator of the process innovation, namely X21 (the process of making ceramics are using new methods to improve the quality of the product) is 0.814, X22 (the process of making ceramics by increasing complementary activities to accelerate the process of production) is 0.955, X23 (the process of making ceramics considering the cost savings and time) is 0.859, and X24 (using new methods to increase ceramics shipment to the consumer) is 0.842. The X22 is the greatest item indicator, meaning that the process innovation that is implemented use complementary activities to speed up the production process. Item indicators of innovation of financial performance Y11 (increasing production for last 2 years) is 0.9, Y12 (increasing marketing for last 2 years) is 0.894, and Y13 (increasing profit for last 2 years) is 0.841. Item Y11 is the greatest indicator, meaning that improved financial performance is determined by the amount of production that always increase.

The correlation coefficient of product innovation on the financial performance is 0.51 and the correlation coefficient of process innovation on the financial performance is 0.42. The correlation coefficient strengthen the hypothesis 1 (H1) which stated that the higher level of product innovation will improve the financial performance of Ceramic Crafts small and medium enterprises in Malang, Indonesia. The correlation coefficient also strengthen the hypothesis 2 (H2) which stated that the higher level of process innovation will improve financial performance in the Ceramic Crafts small and medium enterprises in Malang, Indonesia. The coefficient of determination (R^2) is 0.51, meaning the independent variables ability in explaining the variance of the dependent variable is at 51%, so the hypothesis H_1 and H_2 is accepted. The result is product innovation and process innovation has a very important role in improving financial performance. Creativity manifested in the form of innovation on products that always follow consumer tastes and process innovation that have speed of production and cost savings will have great impact on the level of sales. The finding is consistent with results of previous studies. Bessant and Tidd (2007) stated that product innovation can provide added value to the products/services designed to meet the needs of consumers; Neira, *et. al.*, (2009) and Ar & Birdogan (2011) states that the improvement of product innovation and process innovation will achieve higher business performance. Najib and Akira (2011) states that there is a significant correlation between innovation (product innovation and process innovation) and business performance, meaning that using innovative practices will create competitive advantage and drive better business performance. Atalay, *et. al.*, (2013) states that the higher level of product innovation and process innovation will improve achievement of company performance. The results also confirm the results of research conducted by Rosli and Syamsuriana (2013), that states that innovation (product innovation and process innovation) has influence on financial performance.

Innovation is the most important way for companies to create new value for customers and competitive advantage, then innovation will give impact on the company's success. Innovation is a critical function in the management, because innovation relates to financial performance. The results of the analysis on the effect of innovation on the financial performance shows that innovation has a positive role on improving the financial performance where the higher level of innovation will increase financial performance of ceramic crafts small and medium enterprises. The test results further interpreted that the ceramics business owners are able to develop the level of creativity to realize the innovations, especially on product innovation

and process innovation. Innovation is a mechanism for enterprises to adapt to a dynamic environment, therefore it is required to create new thoughts, new ideas by offering innovative products and improved services to satisfy customers. Two concepts of innovation suggested is being innovate and capacity to innovate. Being innovate is a thought of openness to new ideas as the cultural aspects of the company, while the capacity to innovate is a company's ability to use or implement the idea, process/new products successfully. Innovation can be implemented on the commodity, services or ideas received by a person as something new, so perhaps it is an idea that has emerged in the past, but it can be considered innovative for consumers who know just now. Sometimes people think that by innovating on something then someone has made positive changes that lead to progress. Opinion is indeed true, but the change (in any form), for some consumers is something that is difficult to be accepted. Product innovation is basically used to fulfill the market demand, so that product innovation is one that can be used as a competitive advantage for the company. Product innovation is positively and significantly affect the company's financial performance.

Product innovation is innovation that is used in the overall operation of the company where a new product is created and marketed, including innovation in all functional processes/usefulness (Crawford & De Benedetto, 2000) and using new technology into a product so that these products have added value (Galbraith, 1973; Schon, 1967). The objective of the product innovation is to maintain the viability of the company, because the existing products are vulnerable to the changing needs and tastes of consumers, technology, short product life cycles, as well as increased domestic and foreign competition. Product innovation must come through market research results, so it can produce the products according to consumer tastes. Although the company is concerned with the quality, but if the company does not pay attention to consumer tastes, it will cause the product that is not in demand, even consumers will switch to another product, so sales will drop that caused decreasing in financial performance. There are several ways that can be taken to produce innovative products (Kotler, 2002), in particular by: (1) developing a new product attribute, (2) develop a variety of quality levels, and 3) develop models and sizes of products.

Product innovation in small and medium enterprises Craft Ceramics in Malang-Indonesia improve competitiveness, by doing some variation on the main products that are most in demand by the consumer's perspective, that 77% of consumers interested in ceramics vase, 36% of consumers interested in ceramics souvenir, and 14% of consumers interested in ceramics jar.

As the demand for various ceramics increased, process innovation is carried out in Ceramics Craft small and medium enterprises in Malang-Indonesia in order to produce a product that superior in competition, by modifying ceramic material portion of soil with gip material. Ceramics manufacture using gip made to save fuel, dried enough, the process to make it is easier than use clay or porcelain. Because the tastes of consumers are different, sometimes still do not fully the consumer demand. The manufacturer of ceramic craft is still small, but the ceramics center has prospects that could be expected. The existence of ceramic supposed to be maintained. Consumers demand for decorative ceramic products should be used by craftsmen by giving capital training to employees and craftsmen engaged in the field of ceramics. Demand for craft products tend to be personal needs, for example for souvenirs, now not only at the wedding which took souvenir, but also at birthday, and others that could use a ceramic as a souvenir. Ceramic craft should continue to evolve through times. Ceramic products are not only as a decoration in every corner of the house. Each home appliances such as ashtrays, spa equipment, cups, spoons, soap dishes, and even a stove for cooking can be applied to the ceramic. The level of creativity at the business center of ceramics craft

SMEs that meet the demand from consumers is essential for ceramics business continuity which fluctuate over the time.

5. CONCLUSION

Development of creativity is to find new ideas and innovation is to create superior competitive and improve financial performance. Likewise, superior competitive and financial performance can be improved when creativity and innovation implemented based on the needs of consumers. Innovation is a way to continue to build and develop organizations that can be achieved through the introduction of new technologies and new applications in the form of products and services, development of new markets and introducing new forms of organization, a blend of those various aspects of the innovation in will form innovation arena. Innovation is not only focus on technical issues, but also related with administrative aspects of the organization (Han, *et. al.*, 1998). Innovation strategies carried out by the owners/managers of ceramics craft SMEs realized in the form of product innovation and innovation of process. Product innovation and innovation of process has been proven to provide a considerable influence on the financial performance. Ceramics business owners are able to develop the level of creativity to realize the innovations, especially on product innovation and innovation of process, and create new value for customers and create competitive advantage. Basically the product innovation fulfill the request of market, so product innovation is one of the alternative can be used as a competitive advantage for the company. The findings of this research are product innovation is used to produce ceramic products that are always new and fulfill the taste of consumers (up to date), and process innovation is used to produce high quality products by using supporting activities to speed up the production process. Process innovation is needed to increase productivity levels that are associated with increased employee satisfaction, improve the delivery of products or services to the customer, control and reduction of waste products, control, and reduction in the time and cost of processing. Implications of the research is the marketing of ceramic products should be further strengthened with the promotion through various media in order to create larger market share, and it need the role of government policy of protection about ceramic crafts small and medium enterprises.

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