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The Significance of Entrepreneurial Orientation on Firm Performance Through Innovation Capability

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ABSTRACT
Companies must restructure the resources and capabilities to enhance performance. In a swiftly evolving competitive business environment, these resources and capabilities need to be effectively organized, integrated, and utilized. Consequently, companies should develop an entrepreneurial orientation as a strategy to guide entrepreneurial decisions and activities, focusing on how to leverage resources to convert innovation capabilities into performance. This research investigated the impact of entrepreneurial orientation on innovation capability and firm performance. This study focused on SMEs in Bali, Indonesia, with a sample size of 396. Data were gathered from managers of these SMEs, who served as the research respondents. An online questionnaire was administered through Google Forms and sent via email, resulting in 168 valid responses. Data analysis was performed using SEM PLS, with WarpsPLS 7.0 software. The results indicated a significant impact of entrepreneurial orientation on innovation capability and firm performance. Additionally, innovation capability positively and significantly influenced firm performance. The study also revealed that innovation capability mediates the relationship between entrepreneurial orientation and firm performance. When discussing innovation capabilities, refer to the routine actions involved in configuring capabilities and resources. Enhancing performance requires more than merely altering these capabilities and resources. Entrepreneurial orientation must play a crucial role in intensifying a company's innovation capabilities, which are essential for transforming into firm performance.

1. INTRODUCTION

In examining the global SME landscape, research from diverse economic environments provides insight into the universality of SME challenges and successes. Studies on SMEs in developing economies emphasize the sector's role as a critical driver of economic growth and job creation (He & Wu, 2024), reinforcing findings from developed economies where SMEs are noted for their adaptability and innovative potential (Jiang et al., 2023). For instance, Latin American SMEs often face financial constraints but demonstrate resilience through local resource optimization, contrasting with European SMEs that benefit from more structured regulatory support (Garrido-Moreno et al., 2024). Meanwhile, studies from the Asia-Pacific region highlight unique challenges in balancing innovation with traditional business practices, a trend observed among SMEs in China and India where market dynamics require rapid adaptation to technological shifts (Jiang et al., 2023). Additionally, African SMEs encounter distinct obstacles in accessing credit but show remarkable adaptability through informal networking and resource-sharing practices (Mogashoa & Selebi, 2021). Collectively, these global insights underscore how varied economic conditions influence SME resilience and innovation capabilities, providing a comprehensive perspective on the sector's pivotal role across different economic systems.

A vibrant and dynamic small and medium enterprise (SME) sector is crucial for national economic development (Yoshino & Taghizadeh-Hesary, 2016), especially in an increasingly competitive and challenging environment. SMEs are recognized as key drivers of growth and essential to economic progress. According to (Abbas et al., 2019), most countries depend on the performance of SMEs to grow and improve their economies. However, SMEs face unpredictability and challenges in the competitive business landscape (Ratanova & Voroncuka, 2021), and adverse conditions have made it even harder to improve their performance. It is essential to recognize that SMEs are fundamentally different from large corporations and not merely smaller versions of

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them (Ha et al., 2021). Due to limited resources, many SMEs cannot pursue numerous strategic options without spreading themselves too thin. SMEs generally have less financial and human resource flexibility compared to larger companies (Petković et al., 2016). Nevertheless, SMEs have an advantage in being more flexible, adaptable, and less bureaucratic (Gherghina et al., 2020). They can adjust to a changing and unpredictable environment, aligning internal resources with external demands to survive and sustain performance.

SMEs encounter various establishment challenges in a dynamic environment that offers opportunities for growth and performance (Elhassan, 2019). The outcomes of a company's business activities are referred to as SME performance, which is measured using several significant indicators identified as firm performance measures in previous studies (Aziz & Samad, 2016). SMEs focus heavily on achieving sustainable performance through the most effective resource utilization strategies, which test their innovation capabilities and entrepreneurial orientation (Hanifah et al., 2022). From an innovation capabilities perspective, this is a critical competency that enhances SMEs' ability to generate innovative solutions and improve firm performance (Correia et al., 2020). Innovation capabilities, viewed as a complex phenomenon, involve how these capabilities are used to achieve business strategy and have been shown to precede firm performance (Nasser, 2021). Additionally, innovation capabilities refer to a company's ability to effectively integrate, develop, and reorganize internal and external competencies in response to rapid environmental changes (Muangmee et al., 2021). (Adam et al., 2022) confirmed that innovation capabilities serve as a mediating factor between resources and performance in unpredictable environments, where internal and external company resources alone do not directly impact firm performance.

The success and sustainability of firm performance are determined by internal strategic capabilities (Dias et al., 2021), such as entrepreneurial orientation, which are crucial in today's highly competitive environment. Firm performance hinges on the development of knowledge-based resources and understanding which knowledge is most important to cultivate (Yu et al., 2022). One compelling reason for SMEs to explore strategic orientation is that firms with an entrepreneurial orientation typically empower employees to make independent decisions (Chou et al., 2020). This involves actively introducing innovations, taking calculated risks, acting proactively, and exhibiting a certain level of aggressiveness in competing with rivals (Covin et al., 2020), all of which can enhance firm performance. Company resources can become obstacles if they fail to adapt to the changing environment and overlook current issues. However, the complex relationship between entrepreneurial orientation and performance may involve other variables, which can vary depending on the external environment and the firm's internal resources (Kungwansupaphan & Leihaothabam, 2019). Additionally, (Lumpkin & Dess, 1996) and (Dess & Lumpkin, 2005) highlighted that entrepreneurial orientation requires consideration of various impacts, including independent, mediating, moderating, and interaction effects.

This study adds to the literature on entrepreneurial orientation, innovation capability, and firm performance by being the first to examine the mediating role of innovation capability between entrepreneurial orientation and firm performance in Indonesia's SME sector. It also highlights how SMEs can adapt to change and improve performance by leveraging innovation capabilities and adopting entrepreneurial orientation.

Entrepreneurial orientation

Entrepreneurial orientation is a strategic business approach that forms the basis for decisions about innovation and competition (Nofiani et al., 2020). It encompasses a company's strategy for innovativeness, proactivity, and risk-taking in creating and implementing practices (Covin et al., 2020). Innovativeness indicates an organization's ability to seek new ideas and engage in creative processes to generate new products and services (Linton & Kask, 2017). Proactivity shows a company's tendency to identify and exploit attractive market opportunities ahead of competitors (Kiyabo & Isaga, 2020). Risk-taking reflects the willingness and readiness of managers to allocate company resources to activities with uncertain outcomes and significant failure costs (Galbreath et al., 2020). In entrepreneurially oriented companies, employees are typically encouraged to take calculated risks, make independent decisions, actively promote innovations, act proactively, and compete aggressively (Chou et al., 2020). The strategic orientation demonstrated through entrepreneurial decision-making is often characterized by high complexity, and dynamic capabilities manage this complexity to enhance firm performance (Pappas & Brown, 2020). Properly applied entrepreneurial orientation improves a company's ability to collaborate with other firms, government agencies, and internal stakeholders, facilitating efficient resource mobilization (Q. Yu et al., 2022). The dimension of entrepreneurial orientation focuses on a company's attitude toward innovativeness, proactivity, risk-taking, and aggressiveness, which are key to strategic decision-making (Chou et al., 2020).

Innovation capability

Innovation capability involves the development and application of knowledge to generate substantial new economic and social value for an organization (Miles, 2019). Innovation encompasses the discovery of ideas

(Migdadi, 2022) that drive continuous development and improvement. The need for innovation capability arises from the rapidly changing and increasingly competitive business environment. Innovation acts as an organizational mechanism to adapt to dynamic conditions (Maldonado-Guzmán et al., 2019) and can be categorized into three types: product innovation, process innovation, and market innovation. The success of an organization's innovation capability is a key factor in its competitive ability (Da Silva & Silva Cirani, 2020) and largely depends on how well the organizational environment accepts the characteristics of innovation, such as relative advantage, compatibility, complexity, trialability, and observability (Rogers et al., 2019). Furthermore, (Rogers et al., 2019) also suggest that innovation capability extends beyond knowledge and includes the organization's perspective on social change. Effective innovation capability enhances organizational performance, leading to a sustainable competitive advantage (Migdadi, 2021).

Firm Performance

Although scholars generally agree that firm performance is a dependent variable in entrepreneurship studies, there are no universally accepted measures of firm performance (Kiyabo & Isaga, 2020). Various methods have been used in prior studies to evaluate firm performance, with financial performance measures being more commonly used than non-financial indicators. According to (Chong, 2008), examples of financial performance indicators include profit before tax, profit per employee, revenue growth, and employee growth. Non-financial performance measures include customer satisfaction, customer referral rate, customer base growth, and market share (Chong, 2008). The different results reported in the literature are likely due to the use of various performance measures (Shepherd & Wiklund, 2009). It has been suggested that personal wealth measurements, alongside financial and non-financial measures, can be used in the least developed countries to assess SME performance (Eijdenberg, 2016). SME performance is typically defined as the outcomes of a firm's business activities (Kotane & Kuzmina-Merlino, 2017), and can be quantified using a variety of indicators, with firm growth indicators being particularly important for SMEs.

The relation of entrepreneurial orientation to innovation capability and firm performance

The relationship between entrepreneurial orientation (Chou et al., 2020) and innovation capabilities (Yu et al., 2022) involves reconfiguring resources and capabilities to achieve performance goals. Integrating entrepreneurial orientation with innovation capability can proactively transform organizational processes and systems to achieve sustainable performance (Jiang et al., 2018; Rehman et al., 2020). Entrepreneurial orientation focuses on internal organizational resources and activities, highlighting the importance of resources in enhancing firm performance (Ziyae & Sadeghi, 2021). To sustain performance, companies need unique and hard-to-imitate resources and the proper use of entrepreneurial orientation to effectively mobilize and coordinate these resources, connecting stakeholders such as governmental organizations and business partners (Burvill et al., 2018; Nagano, 2020). The dimensions of entrepreneurial orientation address risk-taking, which is crucial for decision-making, R&D, and firm performance (Pee & Kankanhalli, 2016). Although entrepreneurial orientation can enhance economic performance, it involves innovative, proactive, and risky behaviors that do not always improve profitability (Hughes et al., 2022). Nonetheless, entrepreneurial orientation significantly impacts corporate performance, with firms practicing it often leading in developing and implementing innovative practices, thereby enhancing performance (Yang & Aumeboonsuke, 2022; Fang et al., 2022). Therefore, this study hypothesis:
H1: entrepreneurial orientation has an effect on innovation capability.
H2: entrepreneurial orientation has an effect on firm performance.

The relation of innovation capability and firm performance

A company can boost its performance by leveraging innovation capabilities, which involve integrating and utilizing resources (Lei et al., 2019). Innovation capabilities, as defined by (Maldonado-Guzmán et al., 2019), rely on unique organizational routines developed over time that competitors find difficult to replicate, thereby enhancing performance. Developing innovation capabilities can lead to improved performance. However, some studies, such as those by (Mugambi & Kinyua, 2020) and (Al-kalouti et al., 2020), have found that innovation capabilities can impact on firm performance. Despite the fact that consistent changes to the organizational resource base don't always guarantee success, (Schilke et al., 2018) suggest that innovation capabilities can enhance efficacy, efficiency, and overall company performance. By improving daily problem-solving abilities and innovation capabilities, companies can increase operational effectiveness and competitiveness by integrating renewable resource bases and continuous performance strategies (Hernández-Linares et al., 2023). Companies systematically develop and maintain their operational routines through innovation capabilities and a learned pattern of collective behavior to enhance effective performance (Park & Xiao, 2020). Ultimately, innovation capabilities focus on improving firm performance by integrating, developing, and reconfiguring internal and

external competencies to adapt to rapidly changing business environments. Therefore, the following hypothesis was developed:
H3: innovation capability influences the firm performance.

The mediation of innovation capability on entrepreneurial orientation to firm performance

Furthermore, (Ha et al., 2021) confirmed that firms need to integrate and build competencies to align entrepreneurial orientation with innovation capabilities to enhance performance (Yu et al., 2023). Companies with an entrepreneurial orientation can create, understand, and impact their environment (Gomes et al., 2022), and (Monteiro et al., 2019) verified that this orientation positively influences performance (Tajeddini et al., 2020). When a company has an entrepreneurial orientation, as noted by (Ha et al., 2021), its innovation capabilities are expected to contribute significantly to firm performance. However, (Kungwansupaphan & Leihaothabam, 2019) demonstrated that the relationship between entrepreneurial orientation and performance is complex, influenced by additional variables and changing with the external environment and available company resources. Moreover, (Hughes et al., 2022) found that an entrepreneurial orientation does not always lead to improved business performance (Vega-Vázquez et al., 2016; Taheri et al., 2019). (Kungwansupaphan & Leihaothabam, 2019) also suggest that entrepreneurial orientation affects company performance in various ways, including moderating, mediating, independent, and interaction effects (Abbas et al., 2019; Chien & Tsai, 2021; Gomes et al., 2022). The hypothesis proposed as follows:
H4: innovation capability can mediate the effect of entrepreneurial orientation on firm performance.

The research was designed to examine both the direct and indirect relationships through which entrepreneurial orientation affects innovation capability and firm performance. The proposed research suggests that entrepreneurial orientation directly influences both innovation capability and firm performance, while innovation capability directly impacts firm performance. Beyond its direct effect, entrepreneurial orientation may also have indirect effects on firm performance. Specifically, the research posits that entrepreneurial orientation indirectly influences firm performance through innovation capability. To achieve the study's objectives, entrepreneurial orientation was used as the independent variable, firm performance as the dependent variable, and innovation capability as a mediator. The research argues that firm performance can be improved through entrepreneurial orientation and suggests that a higher level of innovation capability would further enhance this improvement.

2. METHOD

This study targeted SMEs in Bali, Indonesia, using a sampling frame of 36,387 SMEs registered with the Small & Medium Enterprise Cooperative Service in Bali Province (2024). Given the need to achieve a representative sample that would support the generalizability of findings, the sample size was calculated using the Slovin formula, with a 5% margin of error, resulting in a sample size of 396 SMEs. This approach offers statistical confidence in generalizing findings to the broader SME population in Bali, encompassing diverse industries, business sizes, and market contexts within the SME sector. By capturing a sample that mirrors the population distribution, the study's results can more accurately reflect sector-wide trends, providing insights that are applicable not only to individual SMEs but also to policymaking and support structures aimed at enhancing the resilience and growth potential of SMEs across the province. The selection of respondents in this study focused on managers of SMEs in Bali, Indonesia, because these individuals possess key insights into operational and strategic decision-making within their organizations. As primary decision-makers, SME managers provide critical perspectives on organizational practices, challenges, and responses to market dynamics, which are central to understanding broader patterns within the SME sector. Their roles inherently involve knowledge about resource allocation, business challenges, and adaptation strategies, all of which are crucial for analyzing factors that drive SME success and sustainability. The data were collected through an online questionnaire distributed via Google Forms to enhance reach and convenience. Out of 396 invitations, 168 valid responses were obtained, yielding a 42.46% response rate. The respondent profile and response rate provide a robust basis for interpreting SEM-PLS results and understanding the decision-making processes within SMEs in Bali.

The analysis employed a variance-based Structural Equation Modeling (SEM) approach, specifically the Partial Least Squares (PLS) method, using WarpPLS 7.0 (Kock, 2020). SEM-PLS was chosen due to its flexibility in handling complex models and its ability to produce reliable results even with non-normally distributed data and smaller sample sizes, features that are especially useful in studies involving small and medium enterprises (SMEs) (Kock, 2020). The WarpPLS software, which accommodates both nonlinear relationships and multivariate data, allowed for the analysis of path coefficients, indicator reliability, and model fit indices, enhancing the robustness of the analysis (Hair et al., 2017). In line with guidelines from Hair et al. (2017), this study followed a structured

approach to SEM-PLS by first defining measurement models and then assessing the reflective constructs' validity through reliability tests such as composite reliability and average variance extracted (AVE). The statistical power and sample size requirements were also tested based on model specifications to ensure adequate representation of the relationships hypothesized. To ensure robust measurement of constructs, the variables in this study were assessed using established multi-item scales adapted from previous research. This approach strengthens the validity and reliability of the study's measurements by aligning with validated frameworks and reducing construct measurement error (Hair et al., 2017). Each construct was operationalized with multiple indicators, allowing for a comprehensive assessment of the latent variables and increasing measurement accuracy by capturing different dimensions of the constructs. Each item was rated on a five-point Likert scale, with responses ranging from 1 (strongly disagree) to 5 (strongly agree). This scale format, widely employed in social science research, enhances respondent engagement and improves response accuracy by providing balanced answer choices and equidistant intervals for ordinal responses (Kock, 2020).

Entrepreneurial orientation is measured using 8 items adapted from research (Chou et al., 2020): 1 We are usually the first to find and introduce new products technologies; 2 We are usually the first to introduce new innovations in our market area; 3 We are the innovation leader in the market; 4 We proactive in pursuing market opportunities; 5 We act in anticipation of future problems needs or changes; 6 We track industry trends in anticipation of future developments; 7 We willing to try new management marketing services and produce technology; 8 We aggressively maximize potential opportunities. Innovation capability was measured using 10 items adapted from the research of (Yu et al., 2017): My firm has valuable knowledge for innovating manufacturing and technological processes; My firm has valuable knowledge on the best processes and systems for work organization; My firm has organize resources to the production efficiently; I am able to offer environmentally friendly processes; My firm is able to integrate production management activities; My firm is able to replace obsolete products; My firm is able to extend the range of products; My firm is able to develop environmentally friendly products; My firm is able to improve product design; My firm is able to reduce the time to develop a new product until its launch in the market. Firm performance is measured using 8 items adapted from the research of (Abbas et al., 2019): 1 Our firm profit goals have been achieved; 2 Our firm sales goals have been achieved; 3 Our firm return on investment goals have been achieved; 4 Our products have a higher quality than those of our competitors; 5 We have a higher customer retention rate than our competitors; 6 We have a better reputation among major customer segments than our competitors; 7 We have a lower employee turnover rate than that of our competitors; 8 We have been more effective in new product development than our competitors.

Table 1. Descriptive statistics of variables studied

	Theoretical Score		Actual Score		Mean	SD
	Min	Max	Min	Max		
EO	1	5	3.13	4.88	4.10	0.46
IC	1	5	3.10	4.80	4.07	0.50
FP	1	5	3.00	5.00	4.12	0.56

Source: The Authors, 2024

Descriptive statistical results (see Table 1), with agreeable answers indicated by mean values of 4.10 (entrepreneurial orientation), 4.07 (innovation capability), 4.12 (firm performance), indicating a value close to 4.00. The average respondent agrees with the item being asked, meaning that there is no distance from the respondent's answer. Standard deviation values represent the distribution of data on the variable entrepreneurial orientation, innovation capability, and firm performance. The standard deviation value means that the difference in value from the mean for the variable entrepreneurial orientation (0.46), innovation capability (0.50) and firm performance (0.56). This confirmed that the standard deviation value is smaller than the mean value of entrepreneurial orientation, innovation capability, and firm performance, indicating that the distribution of data does not vary because the standard deviation value is lower than the mean value, so the value tends to be close to the average value and the mean value can be used as a good representation of the overall data on the entrepreneurial orientation, innovation capability, and firm performance variables.

Table 2. Descriptive statistics of respondent profile

		Frequency	Percent
Gender	Female	33	19.6
	Male	135	80.4
	Total	168	100
Age	20 - 30 years	20	11.9
	31 – 40 years	55	32.7
	41 and above	93	55.4
	Total	168	100
Education	Undergraduate	148	88.1
	Postgraduate	20	11.9
	Total	168	100
Work Experience	1 – 5 years	55	32.7
	5 and above	113	67.3
	Total	168	100

Source: The Authors, 2024

As previously mentioned, the final data consisted of 168 replies. The current study is based on data collected from managers representing SMEs as research respondents. As a result, data can be collected from the SME respectively (Tabel. 2). Based on the final data collected, 33 students identified as females, which represented 19.6% of the data, while 135 students identified as male, making up 80.4% of the data. According to the age division of the data, 20 respondents identified in the age group of 20 – 30 years, which constitutes 11.9% of the data, and 55 respondents identified in the age group of 31 - 40 years, which constitutes 32.7% of the data, and 93 respondents identified in the age group of 41 and above, which constitutes 55.4% of the data. In addition to this, in terms of education, 148 of the respondents have reported as undergraduate, which constitutes 88.1% of the data, 20 of the respondents have reported as working students, which constitutes 11.9% of the data. According to the work experience, 55 respondents identified in group of 1 – 5 years, which constitutes 32.7% of the data, and 113 respondents identified in the group of 5 and above work experience which constitutes 67.3% of the data.

3. RESULT AND DISCUSSION

A. Results

The results of the goodness of fit evaluation (table 3) refer to (Hair et al., 2017) that this research model has an APC value of 0.606 with a p-value of < 0.001 and an ARS of 0.808 with a p-value of < 0.001 and AARS of 0.807 with a p value of < 0.001. Meanwhile, AVIF is 4.316, which is smaller than 5 (Hair et al., 2017), that mean, there is no vertical and lateral multicollinearity and the criteria of goodness of fit was met significantly in the research model.

Table 3. Results of goodness of fit research model

Evaluation	Value	Criterion
APC	0.606*	significant if < 0.05
ARS	0.808*	significant if < 0.05
AARS	0.807*	
AVIF	4.316	acceptable if <= 5

*All significant at p< 0.001

Evaluation of validity measurement instruments (table 4) refers to (Fornell & Larcker, 1981), consisting of: convergent validity with an average variance extracted (AVE) value greater than 0.5 indicating the validity of the indicator variables, namely: entrepreneurial orientation of 0.791, innovation capability of 0.720 and firm performance of 0.792. For predictive validity, all research variables are measured from the q-square value of the endogenous variables of the research model, namely: the innovation capability of 0.745 and firm performance of 0.859, which is greater than 0 (zero), thus fulfilling the predictive validity criteria. The reliability criteria according

to (Fornell & Larcker, 1981) were measured by the value of composite reliability and the value of Cronbach's alpha greater than 0.7. The measurement instrument reliability criteria have been met in the study (see table 4), as shown by the composite reliability value (entrepreneurial orientation of 0.832, innovation capability of 0.877 and firm performance of 0.884), and Cronbach's alpha value (entrepreneurial orientation of 0.768, innovation capability of 0.843 and firm performance of 0.849). Meanwhile, convergent validity was also shown by the combination of loadings and cross-loadings in this study (see table 4). Reflective constructs that have a value above 0.70 and a significant p-value (<0.05) meet convergent validity (Hair et al., 2017). The outer loading value in this study i.e., for entrepreneurial orientation, inovation capability and firm performance is above 0.70 and is significant ($p < 0.001$), and the convergent validity for the reflective construct in this study was met. So that the data analysis process can follow by the evaluation of the structural model.

Table 4. Validity and reliability test results

Variables		Factor Loading	AVE > 0,5	Q-square > 0	Composite reliability > 0.7	Cronbach 's alpha > 0.7
Entrepreneurial Orientation	Eo1	0.737	0.791		0.832	0.768
	Eo2	0.814				
	Eo3	0.720				
	Eo4	0. 717				
	Eo5	0. 805				
	Eo6	0.802				
	Eo7	0.746				
	Eo8	0.776				
Innovation Capability	Ic1	0.730	0.720	0.745	0.877	0.843
	Ic2	0.752				
	Ic3	0.772				
	Ic4	0.724				
	Ic5	0.802				
	Ic6	0.777				
	Ic7	0.779				
	Ic8	0.757				
	Ic9	0.804				
	Ic10	0.734				
Firm Performance	Fp1	0.730	0.792	0.859	0.884	0.849
	Fp2	0.724				
	Fp3	0.701				
	Fp4	0.737				
	Fp5	0.801				
	Fp6	0.767				
	Fp7	0.712				
	Fp8	0.799				

*All significant at $p < 0.001$

The results of testing the research structural model can be seen in the following figure:

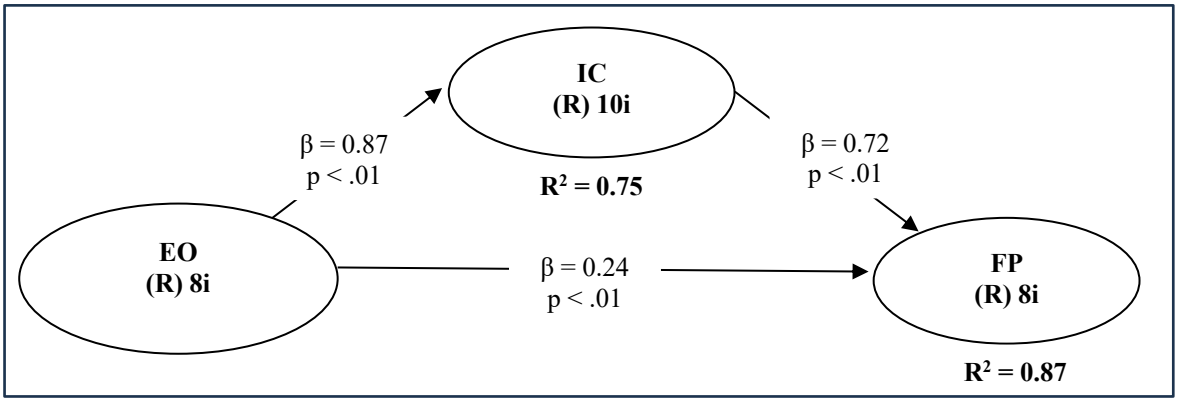

Figure 1. Research model testing results

The results of testing the structure of the research model for hypothesis testing are in the following table:

Table 5. Path coefficient

Variables	Entrepreneurial Orientation	Innovation Capability
Innovation Capability	0.865*	
Firm Performance	0.236*	0.717*

All significant at p<0.001*;

The findings presented in Table 5 highlight several significant relationships within the model, supporting the hypotheses concerning the impact of entrepreneurial orientation, innovation capability, and firm performance. The analysis confirms Hypothesis 1 (H1), showing a substantial influence of entrepreneurial orientation on innovation capability with a path coefficient of β=0.865 (p<0.001). This result underscores the strong role of entrepreneurial orientation in enhancing a firm's innovation capacity, reflecting how entrepreneurial behaviors and strategies drive the ability to innovate effectively. In support of Hypothesis 2 (H2), the results indicate that entrepreneurial orientation has a positive and significant effect on firm performance, with a path coefficient of β=0.236 (p<0.001). This finding suggests that an entrepreneurial mindset within firms is crucial for achieving better performance outcomes, likely due to a proactive approach to identifying and exploiting new opportunities. Furthermore, Hypothesis 3 (H3) is validated by the positive and significant impact of innovation capability on firm performance, evidenced by a path coefficient of β=0.717 (p<0.001). This result implies that innovation capability serves as a critical mechanism through which firms translate entrepreneurial efforts into performance gains. Collectively, these findings highlight the interconnected roles of entrepreneurial orientation and innovation capability in shaping firm performance, affirming that both factors are essential for sustaining competitive advantage and achieving long-term success.

Table 6. Mediation analysis

No VAF	Variable relationship	P → D without M	P → M	M → D	P → D with M	VAF value	Result
1	Entrepreneurial Orientation → Innovation Capability → Firm Performance	0.236*	0.865*	0.717*	0.620*	0.724	partially mediate

Notes: P: predictor, D: dependent, M: mediator variable; * means $p < 0.001$.

The mediation analysis in Table 6 reveals that innovation capability partially mediates the relationship between entrepreneurial orientation and firm performance, with a Variance Accounted For (VAF) of 0.724, categorizing it as a partial mediator according to Hair et al. (2017). Initially, the direct effect of entrepreneurial orientation on firm performance without the mediating variable shows a relatively modest path coefficient of 0.236 (p<0.001). However, when innovation capability is included as a mediator, the path coefficient significantly

increases to 0.620 ($p<0.001$), underscoring the strengthened relationship between entrepreneurial orientation and firm performance due to the mediator's influence. This considerable increase indicates that innovation capability amplifies the effects of entrepreneurial orientation on firm performance, suggesting that entrepreneurial behaviors yield more substantial performance outcomes when directed through innovation processes. Thus, the presence of innovation capability as a mediating factor is critical in realizing the full potential of entrepreneurial orientation, reinforcing its importance in strategic initiatives aimed at enhancing SME performance.

The effectiveness of innovation capability within SMEs can be influenced by several factors. Resource availability, such as funding and skilled personnel, is paramount in enabling firms to develop and implement innovative strategies. Additionally, the organizational culture within SMEs plays a significant role in shaping innovation effectiveness; a culture that encourages experimentation, risk-taking, and learning from failure can drive more robust innovation outcomes. Market conditions, including customer demands and competitive pressures, further shape innovation capability by necessitating that SMEs remain agile and responsive to external shifts. Finally, leadership commitment to innovation also significantly impacts its success, as leaders who actively support and invest in innovation initiatives create an environment conducive to sustained innovation efforts. These factors collectively contribute to the capacity of SMEs to leverage innovation capability as a mediator in enhancing firm performance through entrepreneurial orientation.

Table 7. Effect size and R-squared

Effect Size	Entrepreneurial Orientation	Innovation Capability	Firm Performance
Innovation Capability	0.748		
Firm Performance	0.205	0.663	
R-square		0.748	0.868

Effect size refers to (Hair et al., 2017) with a value of 0.02 (weak); 0.15 (moderate); and 0.35 (large) to measure the effect of latent predictor variables on the structural research model. Table 7 shows that in this study the effect size value of entrepreneurial orientation on innovation capability (large) and firm performance is in the moderate category. The effect size innovation capability and firm performance is in the large category. The effect size value shows the important role of entrepreneurial orientation, innovation capability from a practical perspective in increasing firm performance. To measure the percentage of variance of the endogenous latent variable which is influenced by exogenous variables referring to (Chin, 1998), the R-squared value is 0.67 (substantial); 0.33 (moderate); or 0.19 (weak). In this research model (see Table 7) the innovation capability variable of 0.748 and firm performance of 0.868 indicates the fulfilment of the criteria at a substantial level. The results of this study are in accordance with (Henseler et al., 2009) that if the endogenous latent variable depends on several exogenous latent variables, the R-squared value should at least show a substantial level.

B. Discussions

This study successfully supported the findings of Monteiro et al. (2019), which demonstrated that entrepreneurial orientation influences innovation capabilities. For SMEs in Bali, being entrepreneurially oriented facilitates performance by enhancing innovation capabilities. Entrepreneurial orientation, also known as entrepreneurial strategy, serves as an effective management approach that promotes change and leverages capabilities. It is based on a unique strategic perspective that enhances performance by generating new knowledge, building new competencies, and revitalizing the firm's resources and capabilities in a competitive and challenging environment. Entrepreneurial orientation emphasizes seizing new opportunities and integrating them into the firm's activities. Highly entrepreneurially oriented firms take risks to explore new opportunities. According to Liu et al. (2021), innovation capabilities benefit from higher levels of entrepreneurial orientation as it enhances the ability to recognize opportunities. Therefore, a commitment to entrepreneurial orientation plays a crucial role in managing change and navigating complex environments. An entrepreneurial mindset emphasizes the introduction of innovative concepts, improving threat management and reconfiguration skills. Lim & Kim (2020) found that entrepreneurial orientation positively impacts innovation capability (Monferrer et al., 2021). Entrepreneurial orientation activates the innovation capability embedded in the organization's processes (Tajeddini et al., 2023) by identifying essential resources needed to adapt to changes in the business environment.

These results highlight the positive impact of entrepreneurial orientation on the performance of SMEs in Bali. However, previous studies by Vega-Vázquez et al. (2016;), Taheri et al. (2019) and Hughes et al. (2022) suggested that while entrepreneurial orientation involves innovative, proactive, and risk-taking behaviors, these do not always lead to improved firm performance. This has sparked a significant debate about the true role of entrepreneurial orientation and the mechanisms influencing performance, as the direct link between entrepreneurial orientation and firm performance, according to Chien & Tsai (2021), presents an incomplete

picture of performance outcomes. This study asserts that entrepreneurial orientation is crucial for the performance of SMEs. It promotes entrepreneurial activities that drive performance (Tajeddini et al., 2023). Additionally, Yu et al. (2022) argued that entrepreneurial attitude, rooted in entrepreneurship, includes all actions, strategies, and decision-making processes that contribute to achieving performance. Firms with an entrepreneurial orientation tend to operate more aggressively in highly competitive, dynamic, uncertain, and rapidly changing business environments (Yang & Aumeboonsuke, 2022). These firms often excel in designing and introducing innovations, taking risks, being proactive, and acting aggressively. Moreover, Fang et al. (2022) indicated that the characteristics of entrepreneurial orientation in SMEs significantly influence firm performance. Several empirical studies, such as those by Choi et al. (2020), Lim & Kim (2020), Kiyabo & Isaga (2020) and Chou et al. (2020), have attempted to confirm that entrepreneurial orientation enhances firm performance.

This research effectively demonstrated that dynamic capabilities of SMEs in Bali enhance efficiency and, ultimately, firm performance, consistent with the findings of Park & Xiao (2020). Routine changes to a firm's resource base do not necessarily result in positive performance; rather, dynamic capabilities improve performance by enabling the firm to learn how to implement changes effectively (Hernández-Linares et al., 2023). Dynamic capabilities allow a firm to establish unique organizational and strategic practices and competencies that are crucial for sustained success. Monferrer et al. (2021) suggested that dynamic capability is a long-term process that can significantly impact company performance. Identifying the elements that enhance company performance is vital, especially when examining the influence of dynamic capabilities on high-performing behavior. Although some prior studies, such as those by Kristinae et al. (2023), have found that dynamic capabilities are not directly significant to firm performance, and others have noted insignificant or negative effects (Wilden et al., 2013; Wilden & Gudergan, 2015; Adam et al., 2022), developing strong dynamic capabilities allows a firm to integrate, develop, and reconfigure internal and external competencies to respond effectively to rapidly changing environments and achieve improved performance (Abu-Rumman et al., 2021). According to Ferreira et al. (2020), the process of developing dynamic capabilities involves several key areas, including how these capabilities fit into the overall business strategy. The perspective of dynamic capabilities is a critical competency (Correia et al., 2020) that enhances a firm's ability to create and regenerate performance and identify competitive advantages.

Even though Kristinae et al. (2023) argued that the impact of entrepreneurial orientation on firm performance is not directly significant, and likewise, innovation capability does not significantly influence firm performance, several previous researchers, including Vega-Vázquez et al. (2016), Taheri et al. (2019) and Hughes et al. (2022), also indicated that entrepreneurial behavior may not always enhance firm performance. This study, however, identifies a pathway not previously found: an indirect association between entrepreneurial orientation and performance through innovation capability in SMEs in Bali. These findings also support the perspectives of Lumpkin & Dess (1996), Dess & Lumpkin (2005) and Kungwansupaphan & Leihaothabam (2019) that the effects of entrepreneurial orientation should be considered in terms of independent, mediating, moderating, and interaction effects. The relationship between entrepreneurial orientation and performance is complex and may depend on external environmental factors and firm-specific internal resources. Firms with an entrepreneurial orientation use strategic capabilities to recognize and exploit opportunities and clarify how to achieve performance (Gomes et al., 2022). In this study, innovation capability serves as a mediator, aligning with Adam et al. (2022), who indicated that internal and external corporate resources do not directly impact firm performance. Innovation capabilities act as an intervening variable between resources and performance in unstable environments. Over time, innovation capability can significantly impact firm performance (Monferrer et al., 2021). Additionally, these results contradict prior research, which suggested that the direct correlation between entrepreneurial orientation and performance provides an incomplete picture of performance (Chien & Tsai, 2021) and that it remains unclear how innovation capabilities affect firm performance (Monteiro et al., 2019).

4. CONCLUSION

This study demonstrates a significant interplay between entrepreneurial orientation, innovation capability, and firm performance among SMEs in Bali, reinforcing the hypothesis that innovation capability is a crucial mediator in this relationship. The structural model testing revealed strong positive path coefficients, particularly in the relationship between entrepreneurial orientation and innovation capability and between innovation capability and firm performance. Importantly, when innovation capability was included as a mediating variable, the path coefficient between entrepreneurial orientation and firm performance increased substantially, underscoring innovation capability's amplifying effect on performance outcomes. The study asserts that entrepreneurial orientation fosters enhanced innovation within SMEs, which in turn, drives stronger performance metrics. This conclusion underscores the critical role of innovation capability as a mechanism through which entrepreneurial strategies contribute to overall firm success, offering a robust theoretical framework and practical evidence for SMEs to prioritize both entrepreneurial and innovation-oriented strategies.

By exploring the mediating role of innovation capability, this research enriches the literature on entrepreneurial orientation and SME performance. Prior studies have highlighted the importance of entrepreneurial orientation (EO) in fostering innovative practices; however, the current research substantiates EO as a foundational driver that activates innovation capability, ultimately contributing to performance. This study also aligns with and extends the dynamic capabilities theory by demonstrating that SMEs' entrepreneurial behaviors not only enhance adaptability but, through innovation capability, directly link to performance improvements in competitive environments. Furthermore, the findings add depth to the strategic management literature, particularly in the SME sector, by establishing that a proactive, risk-taking, and innovative approach can yield tangible performance benefits, even in the face of resource constraints typical of smaller firms.

Despite its significant contributions, this study has several limitations. First, the research was geographically limited to SMEs in Bali, which may restrict the generalizability of findings to other regions with differing market conditions, regulatory environments, and cultural factors affecting entrepreneurial behaviors. Second, the study employed a cross-sectional design, which provides insights into correlations but cannot capture causal relationships or dynamic changes over time. Longitudinal studies would better capture the evolution of the interplay between entrepreneurial orientation, innovation capability, and firm performance. Additionally, the reliance on self-reported data could introduce biases, as respondents might overstate their innovation capabilities or entrepreneurial behaviors to reflect positively on their firm. Future research could benefit from using mixed methods or triangulated data sources to minimize potential bias and strengthen validity.

The findings offer valuable implications for practitioners and theorists alike. For SME managers and entrepreneurs, the research highlights the strategic importance of fostering an entrepreneurial culture that promotes innovation as a pathway to performance. By investing in both EO and innovation capabilities, SMEs can position themselves to better respond to market dynamics and sustain competitive advantages. From a theoretical standpoint, this study underscores the relevance of dynamic capabilities and the entrepreneurial orientation framework within the SME context, proposing that innovation capability is a necessary mediating factor to translate entrepreneurial efforts into measurable performance. This reinforces the importance of integrating innovation-focused strategies into EO frameworks and suggests that future research should explore additional mediators and moderators within this relationship to capture a broader spectrum of influencing factors.

Building upon the insights and limitations of this study, future research could expand in several directions. Comparative studies across diverse geographic regions and economic contexts would enhance the generalizability of the findings and reveal variations in how different markets impact the EO-innovation-performance relationship. Further, longitudinal studies could provide a deeper understanding of how these relationships evolve over time and the long-term impacts of innovation capability on firm sustainability and growth. Researchers could also explore additional mediating and moderating variables, such as organizational learning, digital transformation, and external market conditions, to examine how these factors interact with EO and innovation capability to influence performance. Such studies would not only deepen our theoretical understanding but also provide actionable insights for SMEs navigating complex and rapidly changing business landscapes.

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