The Link between HRM Practices and Performance in Malaysian SMEs

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***Abstract*— This empirical study investigated HRM-performance links in Malaysian small and medium enterprises (SMEs). SMEs performance is conceptualized within a multidimensional framework consisting of four dimensions, which are satisfaction with financial performance, satisfaction with non-financial performance, performance relative to competitors and business growth. The five HRM practices adapted consisted of communication and information sharing, compensation, job design, performance appraisal, selection and training and development. The hypothesis of this study has been built on a resource based view. Field research was conducted through surveys with a total of 321 owners/managers of manufacturing SMEs, representing a response rate of 60.5%. Confirmatory factor analyses were used to analyse the quality of the scales and PLS-SEM were conducted to test the hypotheses of the study. Statistical results show certain HRM practices, namely, communication and information sharing and selection are positively related to organizational performance. Finally, this study is useful for future researchers, entrepreneurs and policy makers in realizing the importance of HRM practices towards enhancing SMEs performance.**

***Keywords*—** *Human resource management practices; organizational performance; manufacturing; small and medium enterprises (SMEs).*

1. Introduction

Small-and medium-sized enterprises (SMEs) have been acknowledged as a key business sector for various countries in the world since they make up over 90 percent of all enterprises [1, 2, 3]. In Malaysia, SMEs contribute significantly to the overall economic performance [4, 5, 6]. However, their contributions is still low and they are yet to reach their full potential. The contribution of Malaysian SMEs was also lower than that of the neighbouring countries such as Indonesia (57%) and Thailand (38.9%) ("More efforts needed", 2008). This suggests that further efforts are needed to improve SMEs performance in order to expand the sources of the national economic growth.

SMEs need to know comprehensively the factors that could affect their performance in order to be sustained in country's economic growth. Since the competitors can imitate the advantage of physical and financial resources easily, practitioners and researchers must focus to the uniqueness of human resources as factors that could lead to firm's sustainable competitive advantage [7, 8]. Therefore, it is significant to know in what way to manage human resources which can boost the productivity and control the costs as well [9]. Due to diversity, the growth rate and the rising number of SMEs, HRM can become a strong basis to study in SME [10]. Therefore, a system of good human resource management (HRM) practices need to be addressed as to ensure the development of organizational performance run smoothly [11]. Hence, the purpose of this study is to investigate the relationship between HRM practices (i.e. communication and information sharing, compensation, job design, performance appraisal, selection, training and development) and organizational performance (OP). Next, to further understand the concept of organizational performance, the concept of HRM practices and how it relates to organizational performance will be discussed in the following sections.

2. Literature Review

2.1 Relationship between HRM practices and OP

Undoubtedly, organizational performance is subjectively described phenomenon and becomes

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the most widely studied as a dependent variable in organizational studies [12] since it is engaged with effectiveness, productivity, efficiency, or excellence. In this study perceived organizational performance of SMEs is conceptualizes in four dimensions, which are (1) Satisfaction with financial performance such as profitability, sales turnover, sales growth, return on investment and market share; (2) Satisfaction with non-financial performance such as customer satisfaction, customer retention, relationship with suppliers, business image, workplace industrial relations and work-life balance; (3) Performance relative to competitors in terms of return on sale, cash flow, net profit, market share and return on investment; and (4) Business growth in terms of changes in sales, market share and cash flow [13, 14, 15].

Human capital development is also the key to the success of any business. According to [16], human resources are known as strategic resources which are significant to the organization as knowledge, skills, abilities, behaviors and interaction of the employees. These resources have the ability to influence organization performance. Unfortunately, Malaysia has the labor productivity of SMEs (as measured by real value added per employee) which is significantly lower than the large companies. This was due to a large number of unskilled employees' employment in SMEs particularly in the labour-intensive industries across all economic sectors [3]. As reflected by World Bank surveys [17], the absence of sufficient skilled employees is a major problem for business operations and growth especially for SMEs in Malaysia. To ensure SMEs success, owners/managers need to retrain and upgrade their employees' skills in order to enhance productivity and competitiveness. Though, to develop such employees, SMEs have to implement an appropriate strategy of human resource management (HRM) [18]. Therefore, this study conceptualizes HRM as a combination of several practices that are systematically designed to be geared towards improving SME effectiveness and yielding better performance outcomes [16, 19, 20]. The practices were considered as communication and information sharing, compensation, job design, performance appraisal, selection, as well as training and development. The following discusses each practice in detail.

Over the past decade, previous studies have reported the importance of HRM practices in improving organizational performance [18, 21, 22]. Moreover, SMEs with more effective HRM practices will have better organizational performance because through better HRM, they can achieve the goals of quality standard from ISO certification [23]. Previous empirical studies discovered the positive relationship between communication and information sharing and organizational performance. For instance, [24] also showed that information sharing improved market share and sales through synergistic working relationships that exist between employees. The employee establishes a conducive organizational climate whenever employees exchange information and work together. This will inspire them to give full commitment to the organization which will lead to reduce turnover rate and better organizational performance [25].

In SMEs, it is believed that the practice of compensation policy or reward system give a major impact on organizational performance. [22] found that compensation was one of the most critical practices of business performance. It can be a powerful message to the employees about what they are expected to do in the organization [26]. [24] also proved that the compensation policy had a significant effect on several classification of firm performance, including firm-specific, market-related and overall firm performance.

Job design that provides discretion for their holders, variation and high levels of responsibility is related to job redesign and job enrichment, which are argued to influence the quality of working life of employees, employee well-being and consequently organizational performance [27, 28]. As such, job design should be considered when examining the effects of high performance work system on employee experience of work, employee well-being and job satisfaction [19, 29, 30, 31, 32] and which in turn, improve organizational performance.

According to [25], performance appraisal enhanced organizational performance. [26] asserted that employees need to be evaluated by their managers or supervisors to ensure their employees' performance has been achieved through their work targets to accomplish organizational goals [33]. The implementation of performance appraisal in organization enables employers and employees to review their past performance and prepare themselves to plan for the future organizational performance improvement [26, 33].

Selection or staffing is also one of the most important practices to business performance [22]. In addition, [34] found that proper employees selection supports organizations to grow, yield better productivity, quality as well as higher

profitability. Even though recruitment or staffing practices are different between large and SME firms [35] in that the former adopts more formalized recruitment than the latter, staffing practices are crucial for both [36].

Previous research discovered a positive relationship between training and development and firm performance [37, 38]. Even though training and development is recognized as an important HRM issue in small firms, it is still a neglected area [39, 40]. The reason is most employers often underestimate the benefit and cost of training to small firms as not being worthwhile [40, 41]. Similarly, [34] proposed that training and development practices should be emphasized at every organization level. This continuous training and development activities can increase employees' efficiency and flexibility in their work tasks. Therefore, based on the review of literature on HRM practices and organizational performance, the following discusses the relationship between HRM practices and organizational performance. Accordingly, the following hypothesis was postulated:

H1: Communication and information sharing is positively related to organizational performance.
H2: Compensation is positively related to organizational performance.
H3: Job design is positively related to organizational performance.
H4: Performance appraisal is positively related to organizational performance.
H5: Selection is positively related to organizational performance.
H6: Training and development is positively related to organizational performance.

3. Methodology

3.1 Population and Sample Size

The data in this study were collected from SMEs in manufacturing sectors, including manufacturing, manufacturing-related services and agro-based industries with full-time employees (between 5 to 150 employees) in West Peninsular of Malaysia (Kedah, Penang, Selangor, Wilayah Persekutuan and Johor). The manufacturing sector was chosen due to their average productivity which was much higher than other sectors [17] and it contributed to the highest growth of 7.6% to SME GDP growth in 2011 as well [3]. Out of 531 questionnaires distributed, 321 were returned and usable, amounting to a response rate of 60.5%. The owners/managers of SMEs were the main respondents represent the top management of the firm in the study. This study used a scale adapted by [13] that included four dimensions of perceived organizational performance [14, 15, 42, 43]. The four dimensions were 1) Satisfaction with financial performance, 2) Satisfaction with non-financial performance, 3) Performance relative to competitors, and 4) Business growth. Meanwhile, only six HRM practices that were relevant to the Malaysian SMEs have been selected. They were communication and information sharing, compensation, job design, performance appraisal, selection, and training and development [16, 19]. The six HRM practices were measured using a five-point Likert scale, ranging from 1 = "strongly disagree" to 5 = "strongly agree".

3.2 Data Analysis

Smart PLS 3.0 was used to analyze the data [44]. The two-staged processes involved were the assessment of the reliability and validity of the measurement model as well as the structural model. The research model as in Figure 1 indicates the loading for each item and beta values.

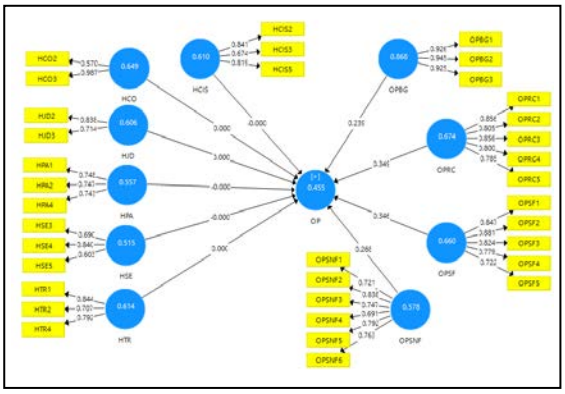

Figure 1. Research model of the study

4. FINDINGS

4.1 Assessment of the Measurement

Confirmatory Factor Analysis (CFA) was conducted to verify the fitness of all the scales. Factor loadings, composite reliability (CR) and the average variance extracted (AVE) were determined to examine the convergent validity. Table 1 exhibits the convergent validity, which revealed all the item loadings above the cutoff value of 0.5 [45]. The loadings ranged from 0.570 to 0.945, specified that the constructs explained more than half of the variance of its indicators. Any loadings

below 0.5 were deleted, resulting in final AVE and CR exceeded the recommended value of 0.5 and 0.7 respectively.

The CR values explain the degree to which the construct items represent the latent, which were in the range of 0.754 and 0.952 that greater than the acceptable cutoff value of 0.7 (45). In addition, [46] asserts the AVE measures "the degree to which a latent construct explains the variance of its items" (p. 114), which is greater than 0.5. The AVE values of HRM practices and OP contructs are exceeded the recommended value of 0.5 which was in the range of 0.578 and 0.868. Table 1 shows the results prove that HRM practices and OP are valid measures of their respective constructs based on their parameter estimates and statistical significance [47].

[46] explains discriminant validity as the degree to which a construct is different from other construct, in terms of how much it correlates with other constructs, and how much items represent only a single construct. The square root of the AVE value of every construct should be exceeded the construct correlations in order to assess the discriminant validity [46]. Table 2 shows that all the square root of the AVE greater than the correlations values with other variable. Overall, the discriminant validity is prevailed. It is concluded from the findings that the measurement model was acceptable based on the evidences of adequate reliability, convergent validity and discriminant validity.

Table 1. Results of Measurement Model

First Order Construct	Second Order Construct	Scale Type	Item	Loadings/ Weights	AVE	CR
Business Growth (OPBG)		Reflective	OPBG1	0.926	0.868	0.952
			OPBG2	0.945		
			OPBG3	0.925		
Performance Relative to Competitor (OPRC)		Reflective	OPRC1	0.856	0.674	0.912
			OPRC2	0.805		
			OPRC3	0.856		
			OPRC4	0.800		
			OPRC5	0.785		
Satisfaction Financial Performance (OPSF)		Reflective	OPSF1	0.847	0.660	0.906
			OPSF2	0.881		
			OPSF3	0.824		
			OPSF4	0.779		
			OPSF5	0.722		
Satisfaction Nonfinancial Performance (OPSNF)		Reflective	OPSNF1	0.721	0.578	0.891
			OPSNF2	0.838		
			OPSNF3	0.747		
			OPSNF4	0.691		
			OPSNF5	0.792		
			OPSNF6	0.763		
	Organizational Performance (OP)	Formative	OPBG	0.239	2.072	20.975**
			OPRC	0.349	2.735	25.593**
			OPSF	0.346	2.842	30.799**
			OPSNF	0.268	1.36	18.623**
Communication & Information Sharing (HCIS)		Reflective	HCIS2	0.841	0.610	0.823
			HCIS3	0.674		
			HCIS5	0.819		
Compensation (HCO)		Reflective	HCO2	0.570	0.649	0.776
			HCO3	0.987		
Job Design (HJD)		Reflective	HJD2	0.838	0.606	0.754
			HJD3	0.714		
Performance Appraisal		Reflective	HPA1	0.748	0.557	0.790
			HPA2	0.747		

(HPA)		HPA4	0.743		
Selection (HSE)	Reflective	HSE3	0.690	0.515	0.758
		HSE4	0.840		
		HSE5	0.603		
Training (HTR)		HTR1	0.844	0.614	0.826
		HTR2	0.707		
		HTR4	0.792		

Note: AVE = (summation of the square of the factor loadings)/ {(summation of the square of the factor loadings) + (summation of the error variances)}; CR = (square of the summation of the factor loadings)/ {(summation of the square of the factor loadings) + (summation of the square of the error variances)}

Table 2. Fornell-Lurker Criterion Analysis for Checking Discriminant Validity

	HCIS	HCO	HJD	HPA	HSE	HTR	OPBG	OPRC	OPSF	OPSNF
HCIS	**0.781**									
HCO	0.077	**0.806**								
HJD	0.302	0.075	**0.779**							
HPA	0.279	0.205	0.227	**0.746**						
HSE	0.534	0.141	0.337	0.138	**0.718**					
HTR	0.524	0.045	0.167	0.305	0.504	**0.783**				
OPBG	0.459	-0.186	0.096	0.059	0.431	0.365	**0.932**			
OPRC	0.344	-0.013	0.226	0.168	0.375	0.302	0.683	**0.821**		
OPSF	0.246	-0.091	0.194	0.153	0.313	0.225	0.667	0.763	**0.812**	
OPSNF	0.206	-0.01	0.113	0.292	0.081	0.16	0.326	0.46	0.509	**0.76**

Diagonals (in bold) represent the square root of AVE while the other entries represent the correlation

4.2. Hypothesis Testing

As this study calls for the measurement of both reflective and formative in the same model, the hypothesis was tested using two-stage approach [46] to examine the relationship between HRM practices and organizational performance. The results from the output of the algorithm and bootstrapping PLS-SEM confirmed that HRM practices, namely communication and information sharing (β= 0.213; t = 3.311; p< 0.01) and selection (β= 0.259; t = 3.556; p< 0.01) has a positive significant relationship with organizational performance, whereas compensation has a negative relationship with organizational performance, as shown in Table 3. Therefore, only hypothesis 1 and 5 are supported while hypothesis 2, 3, 4, and 6 are not supported.

5. Discussion and Future Research

The findings have provided evidence of a positive relationship between communication and information sharing and selection towards organizational performance. The results are consistent with those of earlier studies that concluded that HRM practices (e.g., communication and information sharing and selection) are the crucial input for motivating employees to increase organizational performance [22, 24, 25, 34, 48]. This results can be justified by the flat structure of SMEs which will allow information to be transmitted quickly in the organization. Apart from that, SMEs often adopt flexibility in their management, making information sharing suitable to be applied. The employees establish a conducive organizational climate whenever they exchange information and work together. This encourages them to give full commitment to the organization, leading to reduce turnover rate. Hence, there will be a better organizational performance. SMEs that facilitate their employees to share information, leading to trust development among workers and employers, will in turn, enables SMEs to accumulate all the significant input in order to make decisions that are critical to organizational success.

Table 3. Path Coefficients and Hypotheses Testing

Hypothesis	Relationship	Beta	SE	t-value	Decision
H1	HCIS -> OP	0.213	0.064	3.311*	**Supported**
H2	HCO -> OP	-0.184	0.058	3.169*	**Not Supported**
H3	HJD -> OP	0.016	0.061	0.259	**Not Supported**
H4	HPA -> OP	0.084	0.068	1.244	**Not Supported**
H5	HSE -> OP	0.259	0.073	3.556*	**Supported**
H6	HTR -> OP	0.077	0.069	1.125	**Not Supported**

Note: *P<0.01 (2.33)

Selection was found to be a significant predictor. Employers can make the best choice of who has the expertise needed to develop the organization through the process of recruitment and selection. Although the recruitment or staffing practices tend to be informally done in SMEs, such practice should not compromise the quality of people selected. Thus, through effective recruitment, selection or staffing, employees selected will be an asset to the company as they will produce new ideas in the organization's innovation process [49, 50], which in turn, lead to the performance of organization.

Contrary to expectation, compensations, job design, performance appraisal as well as training and development was not found to be significant in enhancing OP. This finding contradicts previous assertions that these practices need to be included in current studies as it is part of a high performance work system that can affect employee experience of work, employee well-being and job satisfaction [22, 33, 34, 38]. However, it is consistent with [54], who found that there was a slight evidence of a significant interaction between the new invention of human resource practices related to organizational outcomes of performance, innovation, work relations and employee turnover.

The lack of a significant relationship between job design, performance appraisal and training and development towards OP may be explained by the lack of formal approach of HRM practices in SMEs due to the limited size and resource availability [55]. In the Malaysian context, such informal HRM practice may be the norm. In addition, the owners/managers of the sampled SMEs may have not given full empowerment to their employees in carrying out their tasks and all the operations within the organization are still under their supervision. Such style of supervision can demoralize intrinsic motivation that is crucial for creativity and innovative behaviors of employees, which in turn will boost SMEs performance.

Although, prior findings highlighted that effective formal system of reward affects the performance [22, 38], this study shows a contrast result. The negative relationship between compensation and organizational performance can be justified by SMEs which tend to focus on monitoring and controlling rather than employees' development due to their constraints of budget, time, resources and size. Therefore, the need to identify the HRM practices are crucial in order to boost organizational performance in SMEs. However, there is no consensus on which HRM practices support performance. In essence, in taking into account the discussion relating HRM practices and SMEs, the results indicate that SMEs in Malaysia substantially emphasize HRM practices in the fields of strategic HRM practices, but to a lesser extent.

Thus, it can be assumed that in SMEs, HRM probably could not directly affect the performance of the organization, but indirectly affect performance by developing capabilities and behaviors that can increase the activity of innovation and, ultimately to improve the organizational performance. Therefore, the results suggest the existence of the primary mechanism through which the benefits of HRM practice would improve the performance of the organization. In this respect, researchers should also consider possible mediator variables such as organizational innovation, organizational culture, organizational learning capability and knowledge management capacity in order to help us understand mechanisms that explain why HRM practices affect organizational performance in SMEs.

In conclusion, good human resource practices should be in place for such culture to develop. That is, the owners/managers of SMEs in Malaysia need to realize the potential of HRM practices to add value to their organizations. Thus, the findings can be used as a guide to assist SMEs owners/managers to identify which HRM practices that can be observed to improve the current HRM practices. Therefore, it is expected that the new empirical findings of this study can serve as a stimulus to the management of SMEs in order to take into consideration as well as to be more focus on managing human resources by having a formal HRM system and practices. This can be done through the mentor-mentee system with a large organization.

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