

The Practices of HRM, Human Capital, and Organizational Performance: A Literature Discussion in SME Context

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Abstract. SMEs are a very important economic sector in almost all countries. Not only in developed countries but also in developing countries. The reason is, this sector contributes greatly to economic growth, especially to the GDP and employment. Therefore, all governments give a big support to the growth of this sector to contribute even more. The purpose of organizations including SMEs is to increase value for their stakeholders. Therefore, every manager tries hard to improve the performance of his company. In theory, one of the factors that influence organizational performance is HRM practice (Armstrong & Taylor, 2014). However, experts argue that the relationship of HRM practices with organizational performance is an indirect relationship. Therefore, it is important to think about what variables can mediate this relationship. In the literature it is mentioned that human capital can act as a mediating variable in the relationship between HRM practices and organizational performance. However, in the context of SMEs, studies on human capital as a mediator are still rarely found. This present article aims to add to the literature on the mediating role of human capital in the relationship of HRM practices with organizational performance in the context of SMEs.

Keywords: SMEs, HRM practices, mediating roles, human capital, organizational performance

Introduction.

SMEs play an important role in economic growth. Not only in developed countries but also in developing countries. In developed countries like New Zealand, SMEs are 86% of the total business, contribute 27% to GDP (Tarurhor & Osazevaru, 2019). In developing countries like Malaysia and Indonesia, SMEs also contribute greatly. In Malaysia, SMEs comprise 99% of the total business, contribute 31% to the GDP, and to the employment by 56% (Chong, 2012). In Indonesia, SMEs provide employment to as many as 59 million people and contribute to GDP by 60%. These figures indicate that SMEs are the future economy of all countries.

As small organizations, SMEs face big challenges (Tambunan, 2005). Not only external challenges but also internal ones. One internal challenge is the low quality of human resources. Indeed, the success of SMEs is very dependent on HR. Additionally, HR is a competitive resource for SMEs. The higher the quality of HR, the higher the ability of SMEs to compete. The low quality of human resources has affected SME performance. Several surveys report, for example in Indonesia, the performance of SMEs tends to decline. While research in foreign countries revealed that the majority of SMEs failed before the first five years (Ibrahim & Primiana, 2015). Therefore, effective HR management is an imperative thing in SMEs.

In theory, HRM practices have an association with organizational performance (Armstrong & Taylor, 2014). However, the relationship is not clear. There is a missing link in this relationship (Yang & Lin, 2009). Therefore, mediation factors need to be considered. In theory, human capital can act as a mediator in the relationship. This is because human capital has links with HR practices and organizational performance as well. Experts say that a construct can act as a mediator if it has a direct relationship both with the endogenous variable and with the exogenous variable. The study of human capital as a mediator, especially in the relationship between HRM practices and organizational performance has been achieved in the context of large organizations, especially in developed countries. However, in the context of small organizations such as SMEs in developing countries has not been found. This current article aims to add references in the literature regarding the relationship between HRM practices and organizational performance. It also intends to discuss the role of human capital mediation. Hopefully, this discussion can be useful as a reference material for practitioners and further researchers.

Literature Review

Organizational Performance

Experts define organizational performance (OP) differently. Generally, the definitions are based on the viewpoint who defines it. Hence, OP can be defined as the level of achievement of organizational goals objectives (Al-Tit, 2017), organizational outcome compared with the goal achievement (M. Ahmed & Shafiq, 2014), organizational effectiveness and efficiency as measured by financial and non-financial performance (Rezaei, Çelik, & Baalousha, 2011), the capability of achieving goals by deploying resources effectively and efficiently (Daft, 2000; Wade & Recardo, 2001), and behaviors of organization and individuals in the organization (Nudurupati, Bititci, Kumar, &

Chan, 2011). According to Kaplan & Norton (1992), OP is the financial and non-financial indicators to measure the level of achievement of objectives. According to Wilson (2013), OP is the level of success in a certain period by comparing it to the standards and targets.

The definitions above clearly show two important aspects of performance. The first aspect is effectiveness. This aspect is related to achieving goals. Both long-term goals and short-term goals. The higher the achievement of objectives, the higher the effectiveness of the organization. The second aspect is efficiency. This aspect is related to the ratio of resource use to the level of achievement of objectives. The smaller the ratio, the more efficient the organization. Thus, it was concluded that organizational performance can be interpreted as a combination of organizational effectiveness and efficiency. Effectiveness is defined as the level of achievement of objectives while efficiency is defined as the ratio of resource use to the achievement of these objectives (Daft, 2000; Kaplan & Norton, 1992, 1996; Tarurhor & Osazevaru, 2019).

OP is a multidimensional construct. It is called multidimensional because it includes financial and non-financial measures. In the past, performance measurement (or often called traditional measurement) only focused on one aspect, namely the financial aspect. This is due to the view of organizational goals in the past is only to increase financial value for shareholders. Whereas today, the goal of an organization is to increase value for stakeholders. The stakeholders consist of internal elements such as employees, management, and owners, and external elements such as customers, government, or other related institutions.

Traditional performance measurement is a performance measurement based on accounting. Such measurements have the following characteristics: (1) financially based. Because the basis is accounting, financial measures such as profit, return and so on are used as performance measures. (2) internally focused. This means that the focus of assessment is the aspect that exists in the organization, especially the resources owned by the organization. External aspects such as changes in the environment escape from traditional measurement systems. (3) past-oriented. This means that information generated from traditional measurement systems only provides information about the success or failure of past actions. (4) sectoral-focused, not overall-focused. In traditional measurement, the financial aspects measured are not integrated with each other. But it is measured separately. Therefore, the results of these traditional measurements can only be used for decisions on corrective actions on past performance. In other words, it is only to correct what was wrong in the past. Meanwhile, predicting future performance cannot be conducted because the information is not available (Hoque, 2014; Kaplan & Norton, 1996).

As views on organizational goals change from 'shareholder-focused' to 'stakeholder-oriented', the demand for a paradigm shift towards performance measurement also occurs. The researchers want the performance measurement system to use the principle of balance. For example, Keegan, Eiler, & Jones (1989) proposed that performance measurement uses a balance between (1) internal and external aspects, and (2) financial and non-financial aspects. One performance measurement that follows this principle is the Balanced Scorecard (BSC). Kaplan & Norton (1992) initiated and developed a performance accounting model called the Balanced Scorecard (BSC). BSC is a method of measuring organizational performance using four perspectives, namely: (1) financial perspective, (2) customer perspective, (3) internal business process perspective, and (4) learning and growth perspective. Measurement from a financial perspective aims to see the extent to which the organization has the ability to increase value for shareholders. The measure used in this perspective is usually related to financial ratios such as profitability, asset return (ROA), equity return (ROE), and so on. Measurement from a customer perspective aims to see how customers view the company. Common measures used in this measurement are customer satisfaction, customer growth, customer retention, and others related to customers.

Measurement from the perspective of internal processes is related to managerial activities, more precisely related to how resources are used to get high performance. Common measures used in this measurement include the level of productivity, level of efficiency, and so on. Measurement from the perspective of learning and growth aims to see how companies develop, especially in human resources. Common measures used in this measurement include employee satisfaction, increase of employee competency, and so on.

HRM practices

HRM is a strategic management that emphasizes the acquisition, organization, and motivation of HR (Armstrong, 1999). HRM is the daily operationalization of HR management. HRM practices are policies and activities aimed at developing HR potential. HRM practices are investment activities towards HR (Snell & Dean, 1992). HRM practices cover a variety of managerial activities such as recruitment and selection, training and development, compensation, performance appraisal, occupational health and safety. Human Capital Theory states that HRM practices can accumulate and develop human capital (Raineri, 2017).

All organizations must have a good performance to meet the wishes of their stakeholders. Therefore, organizations are highly dependent on qualified, dedicated, passionate and skilled human resources (Armstrong & Taylor, 2014). This is where the important role of HRM practices plays. It is assumed that the organization can

achieve high performance through its human resources (Guest, 1997). Therefore, if HR policies and practices are implemented effectively it can be ensured that HR will have a positive impact on organizational performance. This was reinforced by RBT which revealed that HRM can create competitiveness through the development of existing HR in the organization. Research has also proven that effective HRM practices are positively correlated with high organizational performance (Boxall & Purcell, 2003).

HRM practices are activities that implement HR policies and programs. According to Wright & McMahan, (1992), the practice of HRM is the deployment of HR to make it easier for organizations to achieve their goals. According to Ahmed, Ahmad, & Joarder (2016), the practice of HRM is an organizational activity aimed at improving employee well-being in terms of productivity and satisfaction. HR has an important role in organizational success. Armstrong & Taylor (2014) suggested that the most significant factor in creating competitiveness for companies is HR because HR is able to deal with all changes experienced by the company. According to Goldstain (1991) and Hong, Hao, Kumar, Ramendran, & Kadiresan (2012) training is a programmed and systematic activity of developing employee competencies namely the knowledge, skills and attitudes needed to complete the tasks they carry in order to improve organizational performance. Research shows that employees who attend training have good performance and then contribute positively to company performance. Bontis & Fitz-enz (2002) argues that the practice of training & development is an important investment in human capital. This is consistent with the view of human capital theory which says that companies must invest in employees through training & development activities to get employees who have unique and 'firm-specific' skills.

Lepak & Snell (1999) argued that, in accordance with the RBT, core employee skills should be developed internally. More specifically, as believed in knowledge economy where tacit knowledge is valuable capital, the development of core competences through internal training activities is a very important HRM practice to increase human capital. Meanwhile, Tsui, Pearce, Porter, & Tripoli (1997) found that internal development can improve the quality of human resources, commitment, coordination, and control of employees. This opinion is in line with the findings of Minbaeva, Pedersen, Bjorkman, Fey, & Park, (2003) who say that investing in training can improve the quality of human capital. Compensation is everything that employees receive from the organization as for rearing their work outcomes. Compensation can be in the form of financial or non-financial. (Geiger & Cashen, 2007) argues that the best compensation is the fair and competitive one. Terpstra & Honoree (2003) also argues that attractive compensation is the one that is internally equal and externally competitive. Competitive compensation can bring three benefits to the company. First, competitive compensation can increase employee commitment to the company. Second, competitive compensation can maintain a long-term employee relationship. Third, competitive compensation can help companies to accumulate human capital (Huang, Roy, Ahmed, Heng, & Lim, 2002; Roos, Fernström, & Pike, 2004).

Of all HRM activities, performance appraisal is the most unpopular activity among employees and managers (Bratton & Gold, 1999). Managers don't like it and try to avoid it. Employees consider it useless. However, it is acknowledged that there must be a way to measure, monitor, and control performance (Barlow, 1989). Failure of management to supervise is an extraordinary ineffectiveness. Therefore, the performance appraisal (PA) system can function as an appropriate instrument to ensure that employee performance is on track or well controlled. PA can be seen as a comprehensive analysis of the capabilities and potentiality of employees for decision making related to the achievement of organizational goals (Bratton & Gold, 1999).

Human Capital

Surveys have proven that human capital (HC) is the company's most important asset. However, not all companies operate in ways where human capital is considered important. SMEs, in particular, more often fail to address how important HC is. Many companies are good at improving their financial performance. However, not a few of them fail to involve employees in achieving their company goals. In fact, according to Lawler (2008), human capital if managed effectively will be able to provide long-term competitiveness in companies. Indeed, HC is a vital element for organizations because: (1) it has a role as a source of innovation and strategic change (Obeidat, Tarhini, Masadeh, & Aqqad, 2017; ul Rehman, Rehman, & Ilyas, 2015) and (2) reflects organizational performance (Obeidat et al., 2017). High quality HC can increase productivity, performance and competitiveness of the company. In other words, HC can bring economic value to the company (Falmholtz & Lacey, 1981).

Becker (1964) and Schultz (1961) argue that HC refers to the knowledge, skills and abilities possessed by an individual. HC is a collection of competencies, knowledge, experiences, attitudes, commitments, and wisdom possessed by individuals in the organization. HC consists of ability, behavior, effort, and time. The HC model according to (Tovstiga & Tulugurova, 2007) consists of competence, attitude, and intellectual agility. Competence is a combination of knowledge, skills and experience. Attitudes include motivation, behavior, and mindset. Whereas intellectual agility consists of innovation, creativity, flexibility, and adaptability.

Competencies can be divided into two categories namely organizational competence and individual competence (Namusonge, 2003). Organizational competence is the competency of the organization to achieve organizational goals. This competency is also referred to as 'core competence' which characterizes one organization from another organization. When managed effectively, core competence will provide sustainable competitiveness to the organization (Bergenhengouw, Horn, & Mooijman, 1996). Individual competencies are competencies that must be mastered by employees to complete their work properly. This employee competency consists of knowledge, skills and abilities. Employees who have high competence will produce high employee performance as well. Employee competencies can accumulate to form organizational competencies. Competence is one component of human capital. Competence is defined as the knowledge and skills needed to do a job (Tovstiga & Tulugurova, 2007).

Today, every organization is faced with environmental changes. These environmental changes force organizations to adopt policies to make internal changes. For example, in day-to-day operations, organizations must implement information technology, implement TQM, redesign organizational structures, and even quite radically do business transformation (Bergenhengouw et al., 1996). To implement these policies, it is not enough for an organization to simply copy other organizations that have succeeded in making the necessary changes. However, organizations must focus more on their core competencies. By paying attention to its core competencies, the organization can outperform its competitors in the market. After core competence is considered, the next organizational concern is individual competence (Bergenhengouw et al., 1996) because this individual competency is the basis for developing core competence.

Boam & Sparrow (1992) argue that most organizations today carry out management change policies to adapt to changes in the environment, especially the customer environment. This creates work pressure for the organization because these changes require innovation, creativity, quality improvement (both product quality and service quality), and maintenance of external relations including customers. Facing competition is not enough just to react, but must be proactive on the basis of internal strength. Business success is not enough just to use the principle one step further, but it must be continuously superior. This means that organizations must develop and strengthen core business by mobilizing the strengths that exist in every individual in the organization. In summary, utilizing the internal potential of an organization is a key factor in organizational success.

Of course, the internal potential of the organization lies in the employees. Employee competencies are an important source for the organization. High competent employees will produce high performance which then results in high performance and organizational competitiveness. The question of how an employee gets the competencies that the company needs is an interesting one. Maybe when entering the organization, employees already have their own competencies. However, not all competencies possessed by employees fit with the organizational needs. In addition, employees may already have appropriate competencies but the quality is not yet adequate. Therefore, employees at the start of their work and so on must be given regular training. Effective training will improve employee competency.

The importance of training is not only for new employees but also for old employees. This is due to changes that require the organization to make adjustments including competency adjustments. For example, today, consumers are very critical of product quality and service quality. Meanwhile, employees do not yet have the knowledge and skills for these new demands. Therefore, organizations must respond to these changes by increasing the competence of their employees.

Human Resources (HR) is the most important factor for organizations for one important reason. The one that makes other factors of production in the organization work effectively is HR. Just like organizations, employees also have goals that are also very important to them. Therefore, the manager's job is to ensure that employee goals do not conflict with organizational goals. HRM is a series of activities in which work, employees, and organizations interact with each other as they experience growth and change (Frank, 1974). Therefore, hiring the right employees who fit the needs of the organization is a must. This is an arduous task especially when managers do not understand their needs and motivations. That is why, Koontz, O'Donnell, & Weihrich (1986) advocate the importance of knowing about motivation in management practice.

In general, motivation is defined as the encouragement that employees have to do their jobs. While motivating is defined as the process of giving reasons to employees why they have to work better (Pride, Hughes, & Kapoor, 2014). According to Robbins (2002), motivation is the power that moves, directs, and maintains one's business. According to Luthans, (2002), motivation is a process that begins with the need to activate behavior to achieve goals. In line with Luthans, Flippo (1982) suggests motivation is a psychological process that is triggered by a need that involves actions and directed behavior to satisfy certain needs. While according to McShane & Von Glinow (2015), motivation is the strength that is in a person that influences the direction, intensity, and persistence of his behavior.

The challenge of 21st century managers is how to fully involve employees in organizational activities. This relates to how to motivate employees to work better (McShane & Glinow, 2015). Armstrong (1999) explains that motivation can originate from within oneself which is called intrinsic motivation or from outside oneself which is called extrinsic motivation. Intrinsic motivation arises in a person by searching, finding, and doing work that can

satisfy himself. While extrinsic motivation arises due to the influence of management in certain ways such as rewarding, promotion, or praise. Intrinsic motivation includes several factors such as responsibility, impression, action and job challenges and so on. While extrinsic motivation includes various factors such as rewards, promotions, penalties and others.

In the literature, work behavior is not defined explicitly. Some say, work behavior is work ability. Others say work behavior is all employee behavior related to his work in the organization. However, based on the synthesis of various existing literature it can be concluded that the work behavior of employees is the behavior that employees show in carrying out their work in the organization.

Work behavior is the result of employee attitudes toward work. That attitude can be positive or negative. Therefore, work behavior can also be positive and negative. Positive behavior certainly has a positive impact on the organization. Conversely, negative behavior, detrimental to the organization. It can be concluded that the work behavior of employees is the behavior shown by employees in carrying out their work in the organization. Work behavior is the result of employee attitudes toward work. That attitude can be positive or negative. Therefore, work behavior can also be positive and negative. Positive behavior certainly has a positive impact on the organization. Conversely, negative behavior is detrimental to the organization.

Discussion

HR practices have a relation to human capital. Effective HRM practices can accumulate human capital. That is why, experts say that investment in human resources through proper recruitment & selection practices, effective training & development practices, attractive compensation systems, and objective evaluation of performance are actually investments in human resources. Empirical evidence supports this opinion. For example, Yang & Lin (2009) found that HR practices influenced human capital. Studies also revealed the same thing. Organizational performance as mentioned earlier is the effectiveness of achieving goals. Achieving these goals is highly dependent on HR. Quality HR facilitates the achievement of goals. Human capital is competence, motivation, and work behavior that is inherent in every individual. All these aspects can predict organizational performance. If human capital has high quality, the organization will be able to achieve high performance. Conversely, if human capital is of low quality, it will be difficult for organizations to achieve high performance. In small organizations such as SMEs, HR management is often ignored. They are more focused on aspects of production (Octavia, 2016). As a result, the performance of SMEs tends to be not optimal. Therefore, it is recommended that SMEs improve their human capitals.

Various literature states that HR practices have a relation with organizational performance. However, the relationship must be mediated by other factors such as human capital. This is in line with the view of the RBV which says that human resources are unique resources that cannot be imitated by other organizations. The RBV says that unique resources provide competitiveness for organizations. Investment in human resources through proper recruitment practices, effective training, attractive compensation systems, and objective performance appraisals can increase employee competency and work motivation. Thus, human capital will increase. The theory states that a variable can be a media if the variable has a direct relationship with both endogenous and exogenous variables. HRM practices as endogenous variables are related to human capital. Basically, the practice of HRM is an investment in HR. In other words, human capital is the accumulation of investment in human resources. Therefore, effective HRM practices can create high quality human capital. HRM practices will accumulate human capital and then affect the organization's performance.

Conclusion

Although SMEs are recognized as an important source of economic growth for a nation, researchers' attention to this sector is still relatively small when compared to large organizations. Likewise, research on human capital as a mediator role is also very rare in the context of SMEs. Not surprisingly, there is not much literature on this in SME. Fortunately, researchers' attention to SMEs especially in recent decades has increased. Organizational performance is an important aspect of business operations because performance can indicate business success. Therefore, it is important to know what factors influence this performance so that managers can take strategic policies to improve the performance of their companies. One of the factors that can influence OP is HR practice. However, studies of HRM practices in the SME context are also rarely conducted. The relationship of HRM practices with organizational performance is still under debate. Some experts argue that HRM practices do not directly affect organizational performance. However, this influence must be through other factors. One such factor is human capital. Human capital can mediate the relationship because human capital has a direct relationship with these two variables. However, studies on human capital as a mediator in the context of SMEs are also not very numerous. This article has discussed how human capital is able to function as a mediator variable in the relationship of HR practices with organizational performance in the context of SMEs. However, it still needs to be suggested that researchers conduct empirical studies to prove this hypothesis. It is expected that with the results of empirical studies the managers can add one guideline in

improving organizational performance. The managers, especially SME managers, can also be advised to use this discussion as an input for the management of SMEs, especially in efforts to improve the performance of SME organizations.

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