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The Relation Between Innovation Strategy And Company's Financial Performance Mediated By Intellectual Capital And Internal Process Performance

Hariyati[1)]
Bambang Tjahjadi [2)]

Abstract

This research examines the relation between innovation strategy and company's financial performance through mediation between intellectual capital and internal process performance. The hypothesis in this research is that the innovation strategy affects the financial performance, which is mediated by intellectual capital, and internal process performance. This research is a quantitative research in the explanatory level. The populations of this research are all of the manufacturer companies in East Java. There are 398 companies. The data is collected through questionnaires. There are 135 questionnaires or response rate for 34%. The analysis unit is a business unit. The research respondent is the manager of the business unit in Manufacturing Company in East Java. The research result shows that the intellectual capital and internal process performance mediates partially the relation between innovation strategy and financial performance.

Keywords : *innovation strategy, mediation, financial performance, intellectual capital, internal process performance*
JEL : O31, G32, O34

[1)] Accounting Departement Airlangga University
[2)] Accounting Departement Airlangga University
E-mail : aaan_har@yahoo.com, bambang.tjahjadi@gmail.com

I. INTRODUCTION

The economic development nowadays is controlled by the information and knowledge, which affects the improvement of the attention in the intellectual capital (Stewart, 1997; Hong et.al, 2007). The intellectual capital is a variable to determine the company value (Hong and Hancock, 2007; Guthrei, 2001). Furthermore, Harrison and Sullivan (2000) stated the company's success is affected by the routine ways to maximize the value of the intellectual capital they have. It is in line with Bontis (1998), Bontis et.al (2001) who found that there are a positive and significant relation between structural capital and business performance.

According to Resources-Based Theory, intellectual capital meets the criteria as a unique source, which is able to create the competitive advantage in formulating the value-creating strategy for the company. Some practitioners state that intellectual capital consists of three main elements (Stewart 1997, Sveiby 1998, Bontis 1999). These are human capital, structural capital or organizational capital, and relational capital or customer capital.

Intellectual capital is an important element to achieve the performance. The organizational or company performance is multidimensional. The organizational performance consists of financial performance and non-financial performance. Achieving the expected financial performance needs non-financial performance such as internal process performance. Kaplan and Norton (2009) group the organizational internal process into four. They are operations management process, customer management process, innovation process, and regulatory and social processes.

The organizational or company performance is multidimensional. Measuring the performance by using single measurement dimension cannot give the comprehensive understanding (Bhargava et al, 1994). The performance measurement is expected to integrate the various measurements (Bhargava et al, 1994; Venkatraman and Ramunajam, 1986). Designing the organization performance needs a model, which can describe all of the organizational performance. Moreover, there are some models of multidimensional performance measurement system: Balanced scorecard (BSC) by Kaplan and Norton, (1997), Integrated Performance Measurement System (IPMS) by Bititci et al (1997), and SMART System by Ghalayani and Noble (1997).

Achieving the multidimensional organization performance needs a competitive advantage. Achieving competitive advantage, then, needs a strategy. According to Hambrick (1981), company strategy is a pattern of decision that relates to the performance achievement. There are strategies used by the company, such as prospector typology strategy purposed by Miles and Snow (1978) and differentiation strategy purposed by Porter (2008), which focuses on the competition through innovation process and innovation strategy. It is applied continuously as stated by Terziovski (2002).

Competitive advantage can be achieved by conducting the innovation process, either product innovation or process innovation. Innovation is an organizational capability which is valuable, hard to be imitated, and cannot be changed (Henri, 2006). The innovation is a source of competitive continuous advantage and delivering the positive contribution for the organizational performance. The innovation is a critical factor for the company to compete effectively in the domestic and global market. It is also considered as one of the most important strategies in the organizational strategy (Davila, 2000; Hitt et al., 2001). An organization that has high innovation can develop the competitive advantage and achieve the higher performance level (Hurley and Hult, 1998; Davila, 2000; Weerawardena, 2003).

Innovation strategy affects the company performance through various methods as explained in the contingencies theory. Intellectual capital and internal process performance are important due to apply the innovation strategy, which affects the financial performance. The innovation strategy affects the financial performance through some variables of mediation, such as intellectual capital and internal process performance.

Product and process innovation in the various manufacturing business is an interesting issue in Indonesia because of the short product life cycle. Moreover, the production cost of using lower cost by giving priority to the good quality also becomes an important thing to consider. There are 1266 companies in Indonesia, especially in East Java, which are included in the big and medium manufacturing companies. The growth levels of manufacturing companies have been fluctuating since 2012. Based on the data of Industry and Trade Institution of East java, the manufacturing company in East Java places the third rank in 2012 after DKI Jakarta and East Kalimantan, in the case of export performance. It gives the contribution of 10.04% for the Indonesian Export. Then, East Java contributes the biggest PDB for 20.85% (Industry Magazine, 2013). Facing the globalization era, manufacturing companies in East Java must be having a competitive advantage. Achieving the competitive advantage can be done by applying the appropriate strategy. That is continuous innovation strategy through product innovation and process innovation by considering the role of good intellectual capital and internal process performance. It will affect the company financial performance.

II. RESEARCH QUESTION

Do intellectual capital and internal process performance mediate the relation between innovation strategy and financial performance?

III. THEORITICAL FRAMEWORK

3.1. Theory I/O

The theory I/O explains that the external factor (industry) is more important than the internal factor to achieve the competitive advantage. The main consideration of theory I/O is competition. Power structures analysis is needed in the competition. It is well known as five forces model (Porter, 1985). There are five important things in five forces model: (1) intensity of competitive rivalry, (2) threat of new entrants, (3) threat of substitute products or services, (4) bargaining power of suppliers and (5) bargaining power of customers.

The theory I/O explains that above-ranger return (AAR) for the company is determined by the characteristics outside the company. This theory focuses on the industrial structures or external environment attractiveness, which then focuses on the company internal sources. The external factors meant in the Theory I/O are (1) economic strength, (2) social, cultural, demography, and environmental strength, (3) political, government, and law strength, (4) technological strength.

The previous studied which are related to the I/O model has been conducted by some researchers. The external environment factor plays a role in the business condition because the environmental factors really determine the strategy that will be running (Covin and Covin, 1990; Miller and Friesen, 1982). Ansoft (1991) and Moller and Friesen (1983) stated that the relation between the environment changing and the strategy planning is very strong. It is in the numerous numbers to anticipate the inconsistent changing and condition. Bird (1990) stated that the complexity and the changing of the environment in the certain industry might affect the intensity of strategic planning. The research, which is conducted by Hopkins and Hopkins (1997), concluded that the strategic planning does not affect the financial performance but the financial performance improves the strategic planning. The previous research shows that there are various results related to the performance achievement and Above Average Return that are expected by implementing the fit strategy.

3.2. Resource-Based Theory

Resource-Based Theory states that internal factor is more important than an external factor in the company to achieve the competitive advantage. Resource-Based Theory is a point of view that focuses on the sources and capability as the fundamental principle, which decide the society prosperity. Organizational capital relates to the human capital and physical capital that determine the empowerment process into the company competitiveness and finally can improve the society prosperity. The ability of empowerment actor is determined by the accumulation of various capitals, which are related to the resource based theory. According to Teece.., et all (1997), the dominant of competitiveness depends on the company's' sources. This idea comes from the strategic management that is related to the Resources-Based Theory.

Barney et al, (2011) state that Resources-Based Theory recognizes the company as the group of sources and ability that are owned by the company. The difference between company's sources and capability with the competitors will give the competitive advantage to the company. The assumption of Resources-Based Theory is how the company is able to compete other company to get the competitive advantage in managing the sources they have, which is suitable for the company's ability. According to Resources-Based Theory, to get the optimal result, the sources must meet these following criteria: (1) valuable. It means that the resources will be valuable if it can give the strategic value for the company, (2) rare. It means that the sources must have a uniqueness or in the other words, it is difficult to be found by the competitor and become the company's potency, (3) imperfect imitability. It means that the sources can be the continuous competitive advantage only if the company who does not have this sources, the company cannot get it or cannot imitate those sources, (4) non-substitution. It means that the sources cannot be substituted by the alternative sources.

Knowledge-Based Theory identifies that knowledge which is rare and difficult to transfer and replicate is an importuning resource to achieve the competitive advantage in facing the competition. The company's capacity and affectivity in producing, sharing, and delivering the knowledge and information determine the value which is produced by the company as the basis of continuous company's competitive advantage in a long period (Edvinsson and Malone, 1997; Bontis, 2002; Choo and Bontis, 2002).

Grant (1991) states that according to the Resources-Based Theory, above-average return (AAR) to the certain company is determined by the characteristics of the company. This theory focuses on the resources development or acquisition and the valuable capability that is difficult or impossible to be imitated by the competitor.

3.3. Contingency Theory

According to Otley (1980), the prior thesis of the Contingency Theory is the absence of organizational concept or design, which can be applied universally, everywhere, or in every condition effectively. An organizational design is only appropriate or fit to certain context or condition the use of contingency theory should support the researcher to identify the appropriate condition to design the certain organization and develop the theory that can support it (Riyanto, 1999). The Contingency theory identifies the optimal form to control the organization under the different operating condition and try to explain the operating procedure of controlling the organization.

Otley (1980) argues that Contingency approach is able to explain why accounting system can be different with a certain condition to another condition. Based on its findings, it can be concluded that there are three concepts that affect the effectivity of the accounting system. There are (1) technology, organizational structures, and (3) environment. Contingency approach in the management accounting is based on the premise that there is none of the accounting systems in

universal, which is always appropriate to be applied in every organization. However, it depends on the condition or situation in that organization. The researchers have applied the contingency approach to analyze and design the control system, especially in the management accounting system. Some of the researchers in the management accounting examine it to find the relation between contextual variables such as inconsistency environment, inconsistency task, organizational structures and cultures, inconsistency strategy by using management accounting system design.

3.4. Innovation strategy

In the globalization era, innovation plays a main role to enter the new market, maintain the market target, and improve the company's competitive advantage. Innovation is an important element of the business strategy because innovation has become the important contributor for the competition winning. Innovation has become a focus of the academic research and industry intensively to solve the various business problem faced by the company, in order to achieve the competitive advantage in the global competition (Hitt et al, 2001; Kuratko et al., 2005). The purpose of innovation not only to decrease the cost but also to improve the product and service quality, design the better product, lengthen the product life cycle, and response the customers' needs and demand. Besides that, innovation is conducted to develop new product and service, new organization model and new marketing technique.

Some of the researchers suggest that recent companies have to be more innovative to be able to compete well in their market (Evangelista et al, 1998). The global competition forces the company to do the innovation by decreasing the production cost, improving the ability in technology, and doing the product innovation. Considering those purposes, the company needs to create organizational structures and their jobs, improve the main competence, develop the new structures to response the new market condition and customers' demand, decide the different market, improve the relation and collaboration with other companies, and putting the investment in for the innovation (Ulusoy et al., 2001).

The success of the business in the millennium is determined by the innovation (Hammel, 1999). Innovation is a process in an organization to utilize the skill and resources to develop the product and/or new service, also to develop the new production and operational system that can meet the customer's needs (Jones, 2004). Terziovski (2002) has proved the effect of innovation on the company performance. The continuous strategy, bottom-up, is preferable to improve the customers' satisfaction and productivity (Terziovski, 2002). The top-down strategy is suitable to improve the competitiveness in technology. The result of Terziovski research shows that the radical strategy is appropriate to be used to do the innovation that creates the product changing and process quickly.

To face the inconsistency environment and the challenging competition, some of the companies try to apply some different strategies from the competitors, especially to place themselves as the most innovative company, as the company

that has the lowest cost, and as the most responsive company for the marketing changing. The company, which place itself as one of the most innovative companies, will try hard to find the customers' needs that have not been fulfilled by developing the new product and service to meet these needs. Some of the companies are better, in the case of achieving this purpose because it considers various external and internal factors.

3.5. Financial performance

In Balanced scorecard, financial perspective is the final object for profit-maximizing companies. The financial performance measurement indicates what company strategy, its implementation and execution, and gives the contribution for the improvement of bottom-line. Company financial performance is improved through two basic approaches. There are revenue growth and productivity. The company can get the profitable revenue by strengthening the relation with the customer and selling the product to the consumers at all level. The improvement of the productivity may happen in two ways, such as decreasing the direct and indirect expenses, using the financial and physical asset efficiently, decreasing the working, and fixed capitals which are needed to support the business level. The link between strategies in the financial perspective can be seen when an organization chooses a balance between growth and productivity. This financial performance variable consists of three indicators. There are income growths, decreasing the cost, improving the use of assets and improving the customers' value.

3.6. Intellectual capital

Intellectual capital is significant in determining the company's activities. The idea of intellectual capital was started in 80's which were indicated by the changes from production-based to service to a knowledge-based economy. To utilize the intellectual capital, the company needs to understand what is meant by intellectual capital. By understanding the meaning of intangible assets, the company can arrange and determine the strategy and the policies to evaluate and maximize the productivity of the assets that they think as the most valuable assets.

Some of the writers have a different definition of intellectual capital. Stewart (1997) defines the capital intellectual as the intellectual materials such as knowledge, information, intellectual property, and experience to create the welfare. Knowledge has become an important production factor. Therefore, the intellectual factor must be managed well by the company. Mourritsen (1998) defines the intellectual capital as one of the technology management processes especially to count the company's prospect in the future. The intellectual capital is an intangible asset, which relates to the technology, consumers, contract, data process, personal capital, marketing, location, and goodwill. Harrsion and Sullivan (2000) states that company's success is affected by the company's routines ways to maximize the value of the capital intellectual the company owns that. The intellectual capital gives the diversity of the organizations values, such

as improving the innovation acquisition profit from other company, consumers' loyalty, cost reduction, and productivity improvement.

Intellectual capital covers the entire intangible assets dimension. The definition of the intangible assets according to Indonesian Accounting Unity (2012) assets which do not have form, a non-monetary asset which is identified, and hold the physical substance to be used in the production of supply things and service, and to be borrowed to others or for the administrative purpose. The available sources are the sources that relate to the consumers such as competence, reputation, and loyalty. The competence is identified as the ability to do the certain job at the individual or organizational level. In the individual level, it covers knowledge, skill and behavior. In the organizational level, it covers specific client database, technology, methods, procedure, and organization cultures. The intellectual capital consists of human capital, customer capital and structural capital (Bontis, 1996).

3.7. Internal Process Performance

Kaplan and Norton (2009) put the organization internal process into four groups. They are (1) Operations management process as the basic process, the daily process where the company creates the goods and service in delivering to the customer. Operations management process from the manufacturing company consists of getting the raw materials from the supplier, converting the raw materials into finished goods, distributing the goods to customers, and managing the risk. (2) Customer management process is the activity that enlarges and deepens the relation with the customer, which becomes the target. There are four sets in customer management process. They are choosing the targeted customer, getting the targeted customer, maintain the customer, and developing the customer who has become a target. (3) Innovation processes are the activity, which develops the new product, process, and service which possibly the company to force the market and get the new segment for the customers. Managing the innovation includes four processes. They are identifying the chance for the new goods and service, managing research and developing portfolio, designing and developing new goods and service, and getting the new goods and service to the market. (4) regulatory and social processes are the activity which helps the organization continuously to get the right to operate in the community and environment where the goods are produced and sold. The company manages and reports the regulatory and social performance into some dimensions. Those are the environment, safety and health, employee practice, and community investment.

3.8. Research model

Based on the theory framework, the research model is developed as presented in the picture below. This research model describes that the innovation strategy (STR) affects the financial performance (FP) which is mediated by the intellectual capital (IC) and internal process performance (IPP).

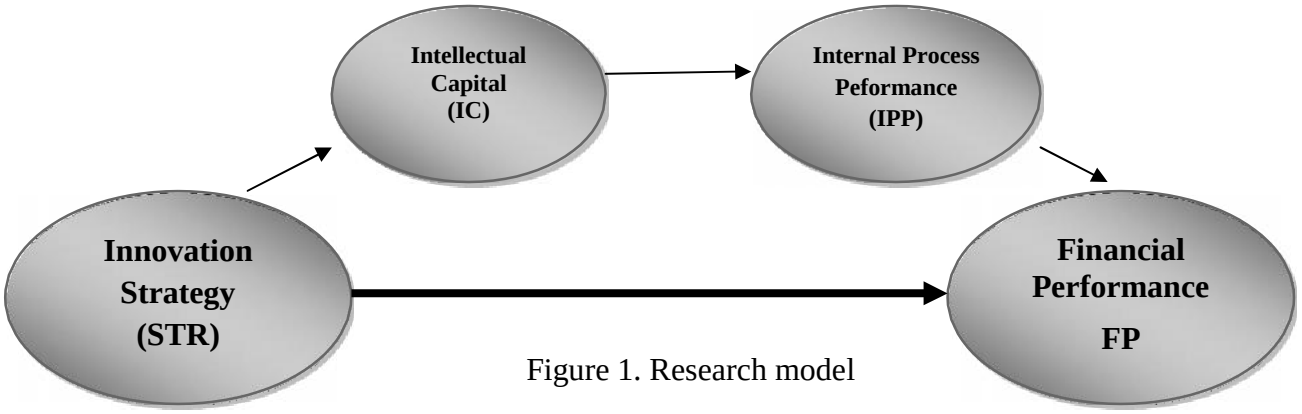

Figure 1. Research model

IV. RESEARCH METHOD

4.1. Research design

This research is designed as causal studies (Cooper & Emory, 1995). This research is quantitative research in the explanatory level that aims to examine the hypothesis whether there is an effect of intellectual capital and internal process performance mediation for the relation of innovation strategy and financial performance. The data is collected through questionnaire. A research analysis unit is a business unit. The research respondents are the manager of the business unit in the manufacturing company in East Java, this research is a research on the behavior that uses the perception of the manager as the part who is assumed to have enough holistic knowledge about the research variables.

4.2. Population and Sample

The population of this research is all of the manufacturer companies in East Java. There are 398 companies. To avoid the lack of responses to the questionnaire, the questionnaire is delivered through fax and email to all of the population. To improve the response rate, the interview is conducted by phone. Meeting the deadline of the data collection, there are 135 questionnaires are filled or response rate for 34%.

4.3. Variable classification

Variables in the research are classified as follows:

(1) The financial performance is dependent variable
(2) Innovation strategy is independent variable
(3) Intellectual capital is mediating variable
(4) Internal process performance is mediating variable

4.4. Definition of operational variable

1. Financial performance

Financial performance is defined because of certain economic decision that is taken from the certain economic action. The financial performance refers to the Balanced Scorecards concept that is developed by Kaplan and Norton (1992) which shows the planning, implementation, and evaluation of the applied strategy. The financial performance variable consists of four indicators. They are income growth, cost saving, improvement of the asset used, and the improvement customers value.

2. Innovation strategy

Strategy, which is meant in this research, is the innovations strategy that is applied continuously which is defined as a way that is used by the company to compete in its industry continuously. The innovation strategy variable in this research refers to the research conducted by Terziovski (2002). The strategy chosen in this research is integrated innovation strategy. The instruments, which are developed in this research, cover two aspects: product and process innovation, and information technology. By using 5 points of the Likert scale, the respondents are given the question related to the company position compare with other companies based on those two aspects.

3. Intellectual capital

Intellectual materials (knowledge, information, intellectual property, experience) which can be used to create wealth are collective mind strength or a set of knowledge that plays roles in the innovation process. In this research, three indicators make the intellectual capital variable: human capital, customer capital, and structural capital. It is measured by using the questionnaire as an instrument that is developed by Bontis (1997). This questionnaire is filled on how far the respondents agree with five Likert scale.

4. Internal process performance

Kaplan and Norton (1992) define the internal process as an internal business process that refers to the Balances Scorecard concept developed. It explains the process how the process is conducted in the organization to support the customer's needs satisfaction. The internal performance covers four indicators: operations management process, customer management process, innovation process and regulatory and social processes.

5. Hypothesis development

The innovation in the strategy implementation needs a role of the intellectual capital that is competent and influence the internal process performance. It is because the innovation in the strategy implementation will improve the company productivity and customer performance that affect the financial performance. Furthermore, the hypothesis in this research: the strategy influence the financial performance that is mediated by intellectual capital and internal process performance.

V. ANALYSIS AND DISCUSSION

Structural Equation Modeling (SEM) - PLS-based variant is used as an analysis of the data. WARP program PLS 3:00 versions is used to test the hypothesis. Analysis of data through is in two stages, namely (1) a direct influence on the relationship of sustainable innovation strategy and financial performance and (2) indirect effect on the relationship of sustainable innovation strategy and financial performance by mediation variables (intellectual capital (IC) and Internal Process Performance (IPP)).

The indirect effect in this study is the effect of mediation on the environmental performance of sustainable innovation strategy relationship with financial performance. Test methods for mediating variable coefficient difference approach. Testing covers the following steps:(a) examine the effect of the independent variable on the dependent variable in the model without the involvement of mediating variables, (b) examine the direct effect of the independent variable on the dependent variable in the model involving mediating variables, (c) examine the effect of the independent variable on the variable mediation, and (d) examine the effect of mediating variables on the dependent variable.

Mediation testing criteria are as follows: (1) variable is declared as a perfect mediation variable (full mediation), if after entering mediating variables, the effect of the independent variable (X) to the dependent variable (Y) decreases to zero (c '= 0) or the effect of variable X to Y which was significant (before entering the variable M) becomes not significant after entering Mediation variable into the regression equation models. (2) Mediation Variables declared as partial mediating variables, if after entering Mediation variables influence the independent variable (X) to the dependent variable (Y) decreased but not to zero (c '≠ 0) or the influence of variable X to Y was significant (before entering the variable M) be remained significant after entering variables into the model equation M regersi but decreased regression coefficient (Kock, 2010, 2011, 2014).

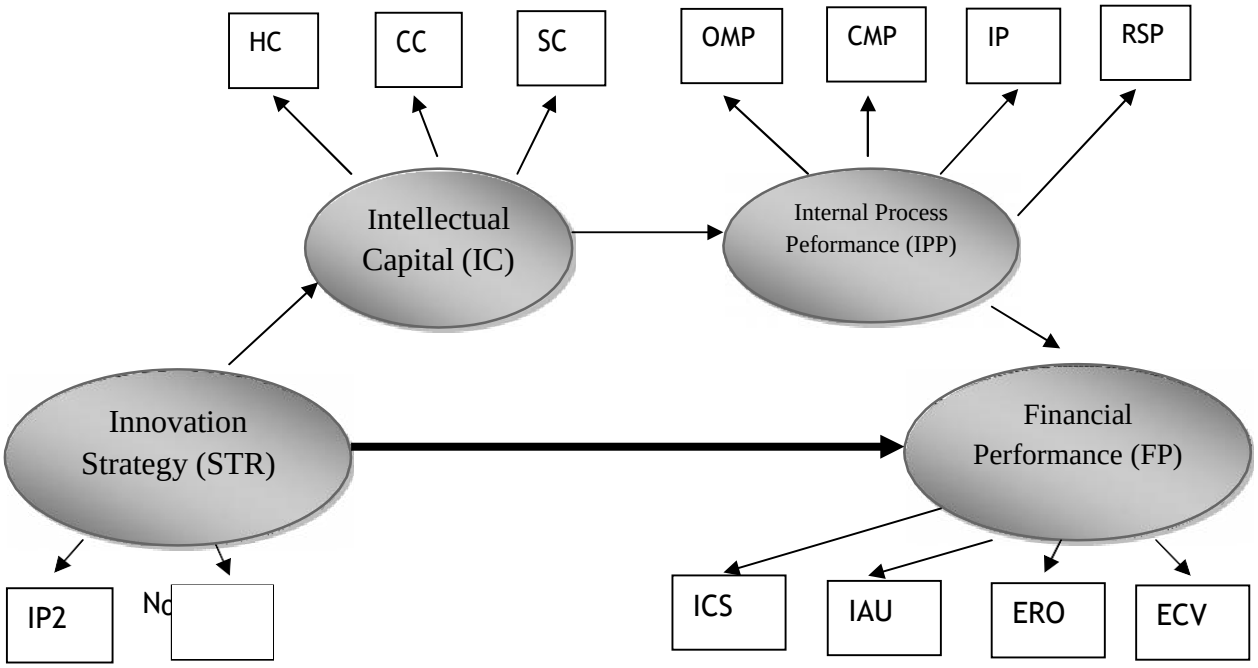

Figure 2. Theory based model development

Note :

IP2 = Inovation Produk and proses

IT = Information Teknologi

HC = Human Capital

CC = Customer Capital

SC = Structural Capital

OMP = Operations Management process

CMP = Customer Management process

IP = Innovation process

RSP = Regulatory dan Social processes

ICS = Improve cost structure

IAU = Increase Asset Utilization

ERO = Expand Revenue Opportunity

ECV = Enhance Customer Value

5.1. Direct Effect Test

Testing the direct effect is to examine the direct effect on the relationship between innovation strategy and financial performance. This test consists of as follows:

1. Validity test

The loading value of STR and FP is more than 0.701 with P-value that is less than 5% (Significant). It means that the construct measurement of STR and FP have met the requirements of convergent validity. The convergent validity also can be seen from the value of AVE, that is:

	STR	FP	SE	P value
IP2	(0.920)	0.079	0.084	<0.001
IT	(0.920)	-0.079	0.095	<0.001
ICS	-0.235	(0.836)	0.059	<0.001
IAU	-0.232	(0.855)	0.054	<0.001
ERO	0.118	(0.917)	0.071	<0.001
ECV	0.321	(0.895)	0.091	<0.001
VALUE of AVE STR 0.847 FP0.768				

The value of AVE from the STR, IPP, IC, and FP is more than 0.50. It means that the construct measurement of STR, IPP, IC, and FP have met the requirements of convergent validity.

2. Reliability test

The reliability test can be observed from Composite Reliability Coefficient and Cronbach's Alpha Coefficient. That is :

Composite Reliability Coefficients	*Cronbach's Alpha Coefficients*
STR 0.917	STR 0.819
FP 0.930	FP 0.899

The value of Composite Reliability Coefficient and Cronbach's Alpha Coefficient from the variable STR, IPP, IC, and FP is more than 0.70, which means that all of those variables are reliable.

3. Goodness of fit

APC=0.730, P<0.001

ARS=0.533, P<0.001

AVIF=1.000, Good if < 5

The average path coefficient (APC) is 0.730. The significant is less than 5%. The average-RSquare (ARS) value is 0.533. The significant is also less than 5%. The average variance inflation factor (AVIF) is 1 which is less than 5. Therefore, it can be concluded that goodness of fit model has been completed.

4. Result of path coefficient

Path coefficients		P values	
	STR FP		STR FP
STR		STR	
FP	0.730	FP	<0.001

The result of path coefficient is positive, 0.730. The significant is less than 5%. It means that STR has significant effect and positive effect for FP. The better STR, the better FP

5. Effect size

	STR	FP
STR		
FP	0.533	

The Effect size value is 0.533 and more than 0.35. It shows that STR has a big effect for FP. It means that STR has an important role in improving FP. The major influence of STR for FP can be seen from the value of R-squared Coefficients. That is 0.533. It means that the major influence of STR for FP is 53.3%.

5.1. Indirect Effect Test

1. Validity test

Loadings core of the indicators STR, IPP, IC and FP is more than 0.70 by P-value that is less than 5% (Significant). It means that the construct measurement of STR, IPP, IC, and FP have met the requirements of convergent validity. The convergent validity also can be seen from the value of AVE, that is:

	STR	IC	IPP	FP	SE	P value
IP2	0.920	-0.037	-0.009	0.095	0.085	<0.001
IT	0.920	0.037	0.009	-0.095	0.095	<0.001
hc	-0.053	0.823	0.007	0.113	0.108	<0.001
cc	0.024	0.744	-0.055	-0.061	0.091	<0.001
sc	0.031	0.852	0.042	-0.056	0.075	<0.001
OMP	0.231	-0.058	0.837	-0.047	0.063	<0.001
CMP	-0.278	0.033	0.844	0.035	0.062	<0.001
IP	-0.181	0.043	0.897	-0.126	0.056	<0.001
RSP	0.238	-0.021	0.855	0.144	0.062	<0.001
ICS	-0.260	0.054	0.015	0.836	0.059	<0.001
IAU	-0.217	0.046	-0.031	0.855	0.054	<0.001
ERO	0.060	-0.063	0.115	0.917	0.071	<0.001
ECV	0.388	-0.030	-0.101	0.895	0.091	<0.001

VALUE OF AVE			
STR	IC	IPP	FP
0.847	0.653	0.737	0.768

The value of AVE from the STR, IPP, IC, and FP is more than 0.50. It means that the construct measurement of STR, IPP, IC, and FP have met the requirements of convergent validity.

2. Reliability test

The reliability test can be observed from Composite Reliability Coefficient and Cronbach's Alpha Coefficient. That is :

Composite Reliability Coefficients				*Cronbach's Alpha Coefficients*			
STR	IC	IPP	FP	STR	IC	IPP	FP
0.917	0.849	0.918	0.930	0.819	0.732	0.881	0.899

The value of Composite Reliability Coefficient and Cronbach's Alpha Coefficient from the variable STR, IPP, IC, and FP is more than 0.70 which means that all of those variables are reliable.

3. Goodness of fit

APC=0.432, P<0.001
ARS=0.341, P<0.001
AVIF=2.545, Good if < 5

The value of average path coefficient (APC) is 0.432 and the significant is less than 5%. The value of average R-Square (ARS) is 0.41 and the significant is also less than 5%. The average variance inflation factor (AVIF) is 2.545 and less than 5. Therefore, it can be concluded that the goodness of fit model has been achieved.

4. The result of path coefficient estimation

Path coefficients					P values				
	STR	IC	IPP	FP		STR	IC	IPP	FP
STR					STR				
IC	0.470				IC	<0.001			
IPP		0.420			IPP		<0.001		
FP	0.352		0.485		FP	0.011		<0.001	

Path coefficient which is got is positive with the p-value which is less than 5%. It means that STR has significant effect positively for the IC. STR has significant effect positively for FP. IC has significant effect positively for IPP. IPP has significant effect positively for FP.

5. Effect size and R-Squared

	STR	IC	IPP	FP
STR				
IC	0.221			
IPP		0.176		
FP	0.257		0.368	

The value of Effect size between STR and IC is 0.221 (medium). It shows that STR has a medium effect for IC. The value of Effect size between STR and FP is 0.257 (medium). It shows that STR has a medium effect for FP. The value of Effect size between IPP and FP is 0.368 (major). It shows that IPP has a major effect for KP. The value of Effect size between IC and IPP is 0.176 (low). It shows that IPP has a low effect for IC.

6. Indirect Effect total

Indirect effects					*P values*				
	STR	IC	IPP	FP		STR	IPP	SIAM	FP
STR					STR				
IC					IPP				
IPP					SIAM				
FP	0.096				FP	0.011			

The estimation result shows that there is an indirect effect of STR for FP through IPP and IC. It is 9.6% and p-value is less than 5%.

VI. ANALYSIS AND DISCUSSION

The hypothesis in this research is strategy affects the financial performance, which is mediated by intellectual capital, and internal process performance. The effect of intellectual capital mediation (IC) and internal process performance (IPP) for the relation between continuous strategies (STR) in the significant level of 5% can be seen through these steps:

(a) The innovation strategy (STR) affects the intellectual capital (IC) in the significant statistic level of 5% and the coefficient value of 0.47 ($p<0.01$).
(b) The intellectual capital (IC) affects the internal process performance in the significant statistic level of 5% and the coefficient value of 0.36 ($p < 0.01$).
(c) The internal process performance affects the financial performance (FP) in the significant statistic level of 5% and the coefficient value of 0.59 ($p < 0.01$).

Based on the identification of those three steps, the intellectual capital (IC) and internal process performance mediates partially the relation between innovation strategy and financial performance. Therefore, the hypothesis in this research is proven. The hypothesis in this research is that strategy affects the financial performance that is mediated by intellectual capital and internal process performance. As what has been explained before that intellectual capital (IC) and internal process performance mediate partially the relation between innovations strategy and financial performance. The intellectual capital is the activator of the company's' value in improving the company's competitive advantages. The companies' manufacturers in East Java are faced by the development of the business environment that is controlled by technology (technology-driven business). If in the past economies, the economy did depend on the sources such as natural resources, tools, and capital to create the value, in the Millennium economy, the economy does depend on the knowledge than physical assets from the organization. The human resources are involved in every activity. The company only needs a small physical job. The company will have more jobs to be done by using though mind capital or we call it as intellectual capital.

The changing of strategy orientation in the knowledge assets needs the understanding that the creation of competitive advantage does depend on the company's ability to create, use and transfer, utilize the rare intangible assets that cannot be sold and is hard to be imitated. In the condition of business environmental changing, which is dynamic, the use of assets based on the sources appears as the answer to the intellectual assets management. Through intellectual capital value, the company can manage and develop the assets got which and be used as the way to achieve the continuous competitive advantage.

Related to the discussion above, the role of the intellectual capital in the manufacturers companies in East Java, the continuous innovation strategy become something which is very important. The condition of manufacturing companies in East Java is booming nowadays. It needs the role of the competent intellectual capital. However, the result of this research finds that the empowerment of the intellectual capital role is still low. It gives negative effect to the internal process

performance. It is proven by the statistic test of the relation between intellectual capital and internal process performance that is not significant.

Based on the result of statistic test result, the relation between internal process performance and customers' performance is significant. It is because the internal process performance which consists of operations management process, customer management process, innovation process, and regulatory and social processes end up in the innovation process, operation, and exsold service, it is in line with the company's condition which affects the financial performance. The good internal process performance will improve the efficiency that finally can affect the management process. It deals with a good relation with customer. It will also affect the financial performance.

Operations management process is an activity to create goods and service through transforming input into output. This activity is treated as fast decision making in the daily business by prioritizing the efficiency level in the use of limited resources. The operative management arranges the management in terms of continuous steering for every business process and supporting process. The result of the research shows that 62 respondents answer really agree, 63 respondents answer agree and 10 respondents give the neutral response for the questions related to the operations management process. It describes the fact the manufacturing company in East Java has conducted operational process well.

Customer management process (CMP) includes how the company gets the customer, how the company maintains the customer and how the company manages their product merk. The result of the research shows that 59 respondents really agree, 64 respondents agree and 20 respondents give the neutral answers for the questions related to the customer management process. It describes that the manufacturing company in East Java have conducted customer management process well.

Innovation process (IP) is an important part of the internal process performance for the strategic implementation. The result of the research shows that 62 respondents really agree, 62 respondents agree, and one (1) respondent gives the neutral answer for the questions related to the innovation process. It shows that the manufacturing companies in East Java have done the product and process innovation well.

Regulatory and social processes (RSP) help the organization continuously to get the right of operating in the community and nation where the goods are produced and sold. The company manages and reports the regulatory and social performances that are related to some important dimension, such as environment, safety and health, employee's practice and community investment. The result of the research shows that 63 respondents really agree, 64 respondents agree, and 8 respondents give the neutral answer for the question related to the regulatory and social processes. It shows that manufacturing companies in East Java have conducted Regulatory and Social Processes well.

Statistically, the internal process performance affects the customer performance. Good internal process performance affects the good customer performance. Good customer performance is shown by the manager who always identifies the customer's segment who have been targeted in the competitive

business unit and measure the business unit performance for the customer in the market segment which has been targeted. The customer performance consists of various measurements, such as customer satisfaction, customer retention, customer acquisition, customer profitability, market share, and account share. In this case, the company increases and improves the product attribute continuously, have a food relation with the customer, and maintain the brand image of the produced products. Based on the research, there are 50 respondents really agree, 62 respondents agree, 16 respondents give the neutral answers, and 4 respondents do not agree with the questions related to the product attribute. Related to the good relation with customers, the result shows that 57 respondents really agree, 57 respondents agree, and 21 respondents give neutral answers. For the question related to the brand image, 62 respondents really agree, 56 respondents agree, 11 respondent give a neutral answer, and 5 respondents do not agree, Based on this result, it can be concluded that manufacturing companies in East Java have very good customer performance because they also improve their product attribute, maintain a good relation with customer, and maintain their brand image. A good customer performance will affect the company's financial performance.

VII. CONCLUSION

Based on the description above, it can be concluded that:

1. The innovation strategy affects the intellectual capital.
2. The intellectual capital affects the internal process performance.
3. The internal process performance affects the financial performance.
4. There is a direct relation between innovation strategy and financial performance.
5. The relation between innovation strategy and financial performance is mediated partially by the intellectual capital an internal process performance.

VIII. RECOMMENDATION

1. In this research, the implementation of the continuous innovation strategy does not pay attention to the product life cycle, the further research needs to consider the product life cycle.
2. In this research, the intellectual capital analysis is the result of human capital, customer capital, and structural capital. The further research is expected to analyze the element of the intellectual capital individually.
3. This research does not separate the respondents from the go public manufacturing company and those that do not go public. The further research is expected to separate between both of them,
4. The further research is expected to be conducted not only in the manufacturing company, which conduct the production process but also to the company that deals with service.

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