

# **The Influence of Internal and External Factors to the Performance of Indonesian Small and Medium Enterprises**

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## **ABSTRACT**

This paper try to answer two basic questions i.e., first, what is the impact of internal and external environment to the performance of Indonesian small and medium scale enterprises. Second, are there any differences between high and low performance SMEs in term of characteristics of entrepreneurship orientation, strategy, structure and environmental uncertainty. One hundred and eighty four respondents were withdrawn from four provinces in Indonesia. Research revealed that entrepreneurships characteristics and strategy as well structure contribute to the performance of Indonesian SMEs. Moreover, it was found that high performance SMEs have different internal and external characteristics compare with low performance firms.

## **INTRODUCTION**

Small and medium enterprises play an important role both in develop and developing countries (Yu, 2001). Some of these roles are as job provider, income distribution through business opportunities and rural development and also increase investment and development of entrepreneurship (Kotey and Meredith, 1997).

The role of small business is more important in developing country, especially for Indonesia (Swasono, 1986). The development of Small and Medium Enterprises (SME) have brought some positive impacts although haven't able to change Indonesian economic structure as a whole. This sector has absorbed 85% of employment in all economic sectors (Wie, 1992; Swasono, 1986). In order to empower the contribution of SMEs to economic development, Government of Indonesia has issued some financial and non financial policies to achieve the goal above (Zainuddin and Basri, 1990). However, there are still some findings about SME bankruptcy while some SMEs very success running their business instead.

Some writers believed that the performance of SMEs are contributed by many factors such internal and external to the SMEs their self (Kotey and Meredith, 1997; Pearce and Robinson, 2002). So far there is no comprehensive study about factors that contribute to development and performance of SME. Based on the facts above, this empirical study is aimed to find out about contribution of the entrepreneurship characteristics of the owner of SMEs, strategy, structure and environmental conditions to the performance of SME in Indonesia. This research is trying to answer the following questions: (1) Which one of the following factors contribute significantly to the performance of SME, entrepreneurship orientation, strategy,

structure or business environment? (2) Are there any differences between highly and low performing SMEs in term of characteristics of entrepreneurship orientation, strategy, structure and environment uncertainty?

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## **LITERATURE REVIEW**

### **Factors determine Company Performance**

Performance of a business is influenced by internal and external factors. These factors are entrepreneurs characteristics of the owner, strategy, structure and business environment (Pearce and Robinson, 2000; Navahandi and Malekzadeh, 1997, Herd, Wafa and Jantan, 2001). Nevertheless, research related with factors contribute toward performance of SMEs are limited. There are only small number of research in developing countries (Bjerke, 2000). In the last two decades, it seems that researches about SME are focused about (1) government role and policy in developing SME (2) Characteristic and performance of SME (Ainuddin and Sa'odah, 2001), except Hashim (2000). In his study, Hashim (2000) by using strategic model approach explained the factors contribute to the performance of SMEs. According this model, there are three strategic factors which determine business performance, they are entrepreneurship orientation, organization structure and external business environment. The integration of three factors above significantly influent business performance.

Crag and King (1988) formulated a model to find out about SME performance. The model explains that financial performance of SME is influenced by management practice as internal factor and by market as external factor. Both variables which influent financial performance are also influenced by characteristic of manager as antecedent variable.

### **Entrepreneurship Characteristics and Performance of SME**

Some research show that there some outstanding attitudes of entrepreneur. Some of the attitude are, risk taker, proactive, more flexible and innovative (Hashim 2000; Kotey and Meredith, 1997; Ainuddin and Sa'odah, 2001). Risk taker attitude shows a tendency to challenge something. This attitude related with commitment to allocate some resources in order to get appropriate return. Risk taker attitude positively related with business performance. A business/company led by this type of manager will able to win competition to cope the market (Ainuddin and Sa' odah, 2001; Collie and Sparks, 2000). Proactive is an attitude which always try to predict the future and preparing some alternative actions to enter the future. Proactive manager will always ready to face environmental change with well planned strategy and lead the company reach better performance than the competitor.

Flexible refers to social attitude and orientation to adapt with environment. Flexible person tend to be informal challenger, self confident, humorous and easy to accept changes (Miller and Toulouse, 1986). Therefore, this person will able to sensitively anticipate environmental

change and make himself succeed in highly uncertain environment (Ainuddin and Sa'odah, 2001). Innovative attitude always make improvement and create a better and different system of activities. This type of manager use to produce new product and service to win the market (Miller and Toulouse, 1986). Therefore a company with this type of manager will highly perform (Kotey and Meredith, 1997)

## **Business Strategy and Performance**

Some experts defined about business strategy and each experts has their own definition (Mintzberg, 1994). For example, Glueck (1980) said that strategy is an action to face environment by empowering coordinated resources in order to reach the goal. Generally, there are three generic strategies at company level which can be used in competition (porter, 1980).

First, *Cost leadership*, a company will try to offer product and service with relatively lower price than competitor. Therefore a company will implement tight control and supervision. Over expenses. Second, *Differentiation*, this strategy rely competitive advantage on unique product and service produced by company without ignoring quality. Uniqueness can be showed in form of frame, technology and customer service. Last, *Focus*, a company will fully empower all resources to serve a certain segment, for example, serving a group of buyer or market segment at certain geography. In serving selected target, a company is able to use cost advantage or differentiation. A company with competitive advantage will perform better than others (Kim and Lim, 1988). However, Keen et.al.,(1998) didn't find any significant relationship between generic strategy and business performance.

## **Structure and Firms Performance**

There are two general organizational structure, mechanic and organic (Burns and Stalker, 1961, in Ainuddin ad Sa'odah, 2001). In mechanic structure, relation pattern is inflexible and formal, there is no division of work, and decision making is centralised. On the other hand, in organic structure, the relationship pattern fairly informal, the decision making involve subordinate and relatively flexible with regulation. Mechanic structure is suitable for stable environment while organic structure is suitable for dynamic environment (Miller and Toulouse, 1986)

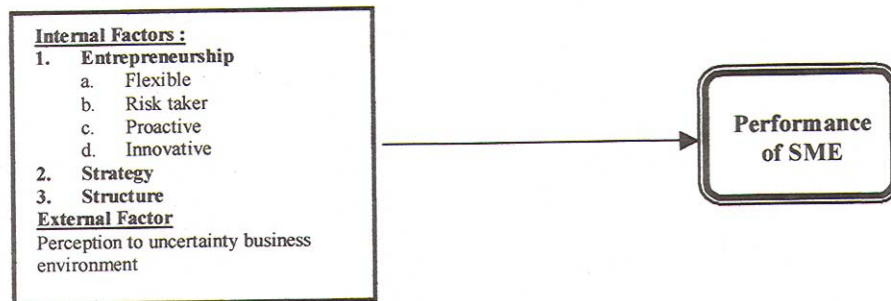
## **Business Environment**

Environment variable consist of physic and social factors which directly considered in decision making of organization (Duncan, 1972). In other word, uncertainty is a perception of someone's inability to predict something appropriately because unable to differentiate between relevant and irrelevant data (Milliken, 1987).

Environment condition directly influent company's ability to reach the goal (Pearce and Robinson, 2000), external environmental change such as, government policy, public taste, technology and socio-cultural bring effect toward company's performance. Freeman (2000) concluded that base on observation in some countries, external condition, especially government policy significantly influent performance of SME.

## Research Model

Base on literature review, this research will use the model, as described below:



**Figure 2. Theoretical Framework**

Research design above shows that performance of company is a function of internal and external factors. Success in improving performance depend on some factors such as attitude, entrepreneurship, strategy, structure and environment.

## Hypotheses

Based on the literature review and research model therefore the hypotheses of this research are:

Hypotheses 1: Entrepreneurship orientation of the owner, organizational structure, strategy and business environment will contribute to the performance of SMEs.

Hypotheses 2 : There will be difference in term of their entrepreneurship orientation, strategy, organizational structure and business environment between high and low performing SMEs

## METHODOLOGY

### Sample

Object and unit of analysis of the research is SME in Indonesian listed in Directory of Indonesia's Manufacturing Company in the 2001. The directory contains information about company's name, address, number of employment, product and contact person of about 20.000 companies.

Mostly SME located in Java & Sumatra, therefore, sample were taken from both island. According to Sekaran (2000) to guarantee generalization of the result of the research for this

research samples were targeted, as much as 377 firms. Anticipating low rate of respond rate, selected samples were greater than targeted sample (Newman, 2000). Based on condition above, the research selected about 500 SMEs as targeted sample by using stratified random sampling. Among the 500 questionnaire send to SMEs chosen as the respondents, only 183 questionnaires returned back, giving the 37 % respond rate.

## **Measurement**

### **Strategy**

Measurement for strategy is adapted and modified from Govindarajan (1989) dan Dess & Davis (1984). There are 12 items used to measure generic strategy prioritized by the SMEs by using Likert-scale from 1 to 7 (from 1 very prioritized to 7 un prioritized).

### **Entrepreneurs Orientation**

Measurement of Entrepreneurs Orientation such risk orientation, innovativeness,

### **Performance**

Financial performance is measured by using average return on equity (ROE) and sales growth in last five years. This measurement Prestasi diukur dalam bentuk data objektif dan diukur menggunakan persepsi manejer/pemilik tentang profitabilitas, pertumbuhan penjualan. Pertanyaan untuk mengukur prestasi subjektif ini menggunakan pertanyaan yang dikembangkan oleh Sulaiman (1989).

### **Entrepreneurship orientation**

This research use the measurement developed by Miller and Friesen (1982); Nahavandi dan Malekzadeh (1997) to measure the entrepreneurship orientation with the some modification and adaptation. The entrepreneurship orientation cover attitude toward risk, innovativeness, flexibility and proactive. There 16 items used that measure using Likert scale from 1 to 7 (from 1 highly agree to 7 highly disagree).

### **Organizational Structure**

This variable is measured by using questionnaire developed by Miller dan Friesen . (1982). Items related with work relationship and Likert berskala 1-7 (highly agree to highly disagree).

### **Environmental Uncertainty**

Environmental uncertainly will be measure by using questioner which developed by miles & snow (1978). The measurement used some question related to environment dimension such as : marketing condition, government policy finance, labor and competition. The measurement used Likert scale from 1 - 7 (from very predictable to very unpredictable). From the questioner

acquired some values which describe perception of manager owner of SME toward environmental uncertainty, the higher the value, the higher the environment uncertainty.

## **Organizational Structure**

Variable of organizational structure will be measured by using questioner which developed by Miller & Friesen (1982). Questioner related to organizational structure by using Likert scale from 1 - 7 (from strongly agree to strongly disagree). The higher the mean score given by respondent, the structure tend to be more mechanistic.

## **Data Analysis**

Number of research simple is 184 SME (Sole proprietorship) samples were taken in 4 different provinces, Jakarta Special Territory, west Java, west Sumatra and north Sumatra. Samples were distributed proportionally in all provinces. Fifty one sample (27,7 %) come from DKI, fifty sample from west java and for west and north Sumatra were 49 and 38 SME

## **Legal form of Company Business**

Composition of sample consist of 95 sole proprietorship firm or 51% of total samples, 51 firms or 27,7% were corporation, 31 firms or 16,8% were limited corporation and 3 samples or 1.6% were cooperation and other 2.2%

## **Number of Employed**

Sample company generally consist of 28 employed, where as minimum number is 5 and maximum number 170. Based on number of employed sample can be grouped into categories. Company with employee < 19 persons, between 20 and 99, and > 99. There 93 companies which have less than 19 employee and 88 company have between 20 to 99 employee and 2 companies have more than 99 employee.

## **How business Started**

Among 183 samples, 149 or 81 % of total sample started the business from 2000. 26 sample or 14.1% more continuity of parents business and sample that start the business through acquisition and other way were 8 or 4.4%. This composition show that company sample are started by entrepreneur.

## **Amount of Equity and Source of Initial Equity**

Majority of initial equity is less than 10 million Rupiah or 94 sample 51.1 % samples that use initial equity four 10 to 50 million Rupiah. There are 42 or 22.8%, 24 samples or 13.0% from 51 to 100 million and 23 samples or 12.5% bigger than 100 million.

Generally initial equity come from saving, 109 samples (59,2%). The second sources are loan/debts, 50 samples (27.2%) and 29 samples or 12% use other sources.

## **Product Market**

Most of 183 samples sell their product around the business location. There are 111 or 60,3% samples sell their product around the business location, 24 samples or 13,0% sell their product to other provinces, while 37 sample or 20,1 % to other town. Sample that export their product just 11 or 6%. Base on market composition, most of SME sell their product around the business location or locally, but some of them have tried to enter international market.

## **Company's Age**

As can be seen in table 4.1, the first SME was started in 1957 and the newest was started in 2000. It means the eldest company is 45 years old, while the youngest is 12 years old. In average most of SME started in 1992 or their average age is 9,377 years.

## **Manager's Characteristics**

Table 2 shows characteristic of entrepreneur of research sample. The characteristic consist of age, position in company and formal education background

### **Sex**

Most of entrepreneur are male, 145 samples or 78,8%, while female just 38 samples or 20,7% from 183 samples.. This composition shows that SME is more interesting for male than female.

### **Position in Company**

As can be seen in table 2, 137 samples or 74,5 of managers are owner of SME. There only 38 samples or 20,7% of sample just as manager, while only 8 samples or 4,3% as member of company. These figures show a phenomena that most of SME are led directly by the owner. There only few SME which led by professional manager

### **Formal Education**

Among 183 samples, more than a half or 45% are senior high school graduates. While bachelor only 12,6% and the smallest are diploma graduate, only 8,7%. This composition shows that generally, educational background of sample are relatively high. It is interesting to note that some of them are bachelor and certainly will influent the way they manage the business.

### **Age**

In average, the age owner are 43 years old, while there are 97 of respondent younger than 43 and 85 elder than 43 years old.

**Table 2**  
**Characteristic of Respondent**

	Frequency	Percentage (%)
<b>Sex</b>		
Male	145	79,2
Female	38	20,8
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Educational Level</b>		
< Junior high school	41	22,4
Senior high school	103	56,3
Diploma	16	8,7
Bachelor	23	12,6
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Age (year)</b>		
<43	97	53
>43	85	47
<b>Total</b>	<b>182</b>	<b>100</b>

## Validity and Reliability Research Instrument

Test Validity conducted with analyze factor to question used to measure the nature of entrepreneurship. to know reliability seen from Cronbach Alpha. Questions. told enough reliable if Cronbach Alpha is the than 0,50. conditions used to determine questions which enter in one factor if loading factor equal or more than to 0,3 and if all loading factor for a few factor, hence the questions aborted because do not authenticity as a means of measure.

## Validity of Entrepreneurship measurement

Factor analyze run for 16 questions used to measure the nature of the entrepreneurship gave 6 factors (variance 64,31 %, KMO=0,645, sig =0,000). First factor consist of 4 question which comprising the nature of innovation, pro-active and risk, pursuant to payload factor from each question, this factor is named with nature of creative and dare to (IRP) with Cronbach Alpha (*ci*) is 0.68. The second factor consist of two question, based on the factor loading the factors is called Innovative (II) and its Cronbach Alpha is 0,68. Third factor contains two item that related with risk and innovation (IP) and its Cronbach Alpha is 0,64. whereas sixth and fifth factor do not have good enough reliability hence it can not be included for further analysis. Instrument reliability can be seen in Table 3 as following:

No.	Names factor Variables	Number of Question	Cronbach Alpha
1	Innovative and Risk Averse	4	0,68
2	Innovative (II)	2	0,68
3	Active pros (PP)	2	0,56
4	Innovative and Active pros (IP)	3	0,64

## Tables 3, Number of Question and Cronbach Alpha of Entrepreneurships Measurement

### Organization Structure and Strategy

There are 15 question used to measure SMES business strategy. Result of reliability test to that question got by Cronbach Alpha equal to 69,90. Reliability test to question which measuring organization structure at SMES obtained by Cronbach Alpha 73,30. this variable can be analyzed furthermore because owning high reliability, from result of reliability test and validity to used instrument hence concluded that the instrument valid enough and reliable.

### Result

Existence of internal factor influence (entrepreneurships, structure of organization, and strategy) to SMES performance. following representing result of hypothesis test use Ordinary Least Square (OLS) analysis, independently variable of nature of entrepreneurships, strategy, structure, environmental with SMES profit margin as variable dependent. from regression analysis seen that internal factor variable which cover the nature of entrepreneurships, strategy, environmental and organizational structure of SMES give contribution to margin of profit variation by significantly ( $R^2=21,7$ , assess  $F=6,94$ ,  $p=0,000$ ). pursuant to result of this analysis hence acceptable hypothesis

Partial analysis show that strategy significantly influence the performance of SMEs ( $t=3,766$ ,  $p=0,0,000$ ,  $B=2,403$ ) so also the things of with environment ( $B=5,040$ ,  $t=6,276$ ,  $p=0,000$ ). Negative number shows progressively SMEs make account of emphasis at repair and thrift (modification) to business operation hence excelsior of performance. Nature of innovative entrepreneurships and take a fancy to risk (IRP), active pros (PP), and innovation by partial influence SMES performance.

**Table 3**  
**Summary Result of Regression Analysis**

Model	B	t	Sig
(Constant)	-4,750	-,559	,577
Environmental Uncertainty	5,040	6,276	,000
STRATEGY	2,403	3,766	,000
STRUCTURE	,277	,243	,808
IRP	7,458	2,915	,004
II	-3,997	-2,044	,043
PP	-2,765	-2,490	,014
IP	-1,544	-1,123	,263
$R^2$	21,7		
F	6,94		
Sig	0,000		

## **Hypothesis 2**

In this hypothesis test, SMES performance to the two group that is which have high performance (margin of profit > sample mean) and SMES of including faction have low performance if small margin of profit from sample mean.

Result of Test T (t-test) seen to have tendency is existence of difference of internal factor (nature of entrepreneurships, strategy, organization structure) and external (environment) among SMES which is have low performance and condition have high performance to SMES which is have high performance to have big margin of profit from 20%, more flange to emphasis strategy and cost-saving repair of process compared to SMES owning margin of profit <10. But that way, this difference not all significant, difference which is significant met for the characteristic of strategy (assess  $F=14,807$ ,  $p=0,000$ ) and nature of active pros (assess  $F=6,011$ ,  $p=0,015$ )

## **Analysis**

### **Internal Factor of SMES And Performance**

Statistical descriptive data show that generally SMES have good performance in the last three year even though Indonesian economy is still in crisis. This can be seen from their performance resilience from SMES in face of environmental situation of business although found the existence of crisis impact to SMES activities (Corpulent, 2000). Efficacy of SMES face crisis might be because of internal factor, like nature of entrepreneurships, relation pattern in used strategy and company in face of change

Nature of entrepreneurships represent of resources which can processed to become excellence compete (Littunen, 2000). Responder measuring up to entrepreneurships like having or creativity have innovative head, like risk and active pros to always to look for unusual action to face emulation of business (Miller & Toulouse, 1986). while less owning responder of creativeness and fear to take risk bring an action against which is "peaceful" and tend to as follower and often lose time in grabbing opportunity (Nahavandi & Malekzadeh, 1993). Creative entrepreneur and innovative also measure up to be never give up and accompanied with attitude like to strive and have life style which orienting at higher level performance (Atkinson, Bartlet & Duchemenaut, 1997)

### **Organizational Structure**

Although result of research shows relation among structure with performance did not find any significant, but that way, from this result is known that at informal structure, flexible and decision making have the character of democratic will push atmosphere creation which is conducive for the creativity. So that will create new idea able to fulfill requirement of consumer (Miller & Toulouse, 1986).

### **Environmental Uncertainty and SMEs'S Performance**

This research show that environment have an effect to SMEs'S performance. Environmental change of external like change of governmental policy, and change of society, technological change and social change of culture giving impact to company which finally will influence

company performance. This result is in line with Freeman's study (2000) that found out that the condition of external environment especially government policy has a significant impact on the SMEs' performance.

The ability in formulating and implementing the strategy in facing the environmental background, personality of manager, job experience, leading company (Herri, 2002). Manager which is innovative and risk taker for example facing change of social values and or technological change by implementing differentiation strategy. Creative and innovative managers tend to create marketing strategy and product and production matching with consumer needs. They can come up with difference and in advance step into market to fill the need of customers and enable to conduct market penetration and improve advantage (Porter, 1980)

## **High and Low Performing SMEs**

Result of research shows that SMEs which have high performance have more giving characteristic emphasis cost-saving, marketing method modification and production, and also build good with consumer and also measure up to active pros. This matter can be explained that company clearly define the way of competing will be more have better performance (Porter, 1980). In a condition changing swiftly hence appropriate strategy is strategy which orienting at unique (Miller & Friesen, 1982) this matter can explain why company which have high performance to differ in the case of strategy compared to company which is have low performance, that is condition of Indonesia business environment changing swiftly is so that needed by strategy which is creative and innovative.

## **Conclusion and Suggestion**

As conclusion of this research is internal factor especially strategy, structure and entrepreneurs orientation contribute to the SMEs' performance. Strategy which prioritize modification and cost-cutting and also the nature of entrepreneurs which active, taking a fancy to innovative and risk taker and play a part in to determine storey; level advantage of SMEs

Perception to environmental uncertainty is also influenced by SMEs performance, this matter because of environmental change which deliver opportunity and threat. Company capable to harmonize change with strategy more success exploit opportunity and threat is minimized.

Ability to yield and strategy adaptation depend on nature of and entrepreneur entrepreneurs characteristic. entrepreneur which is innovative, creative, like to account risk tend to embrace strategy which is "other" or which is unique than with competitors (Herri, 2002) :

Although environmental condition of not yet stabilized because Indonesia not yet convalesce the than economic crisis. SMEs still able to performance menunjukkan is effort good, that is with profitability storey level more than 20%. authorized capital Founding of SMEs generally come from saving, this matter can show that the limited SMEs capital employed in opening effort

Authorized capital used to found SMES come from saving which [is] its limited amount which also pursue them to be able to go further, will very assisting if there [is] skim addressed to assist small industry in founding effort. And development of entrepreneurs orientation such as those which told previously can be disseminated by various method and forum among others with training, discourse, and discussion.

## Implication

This research give contribution to improvement the practice of SMEs, and made as basis for compilation of policy and also add research related with SMEs'S performance. Among its implication is that the importance of developing of nature of entrepreneurs giving contribution to SME's performance like risk averse and innovative. Performance not only influenced by internal factor like entrepreneurs attitude but also by external environment of SMES.

## Future Research

Although the number of sample of this study is quite large enough, however considering the large number of SME's in Indonesia. It is advisable to conduct the same research to confirm the result of this research using larger sample.

This research samples almost 100% are coming from manufacturing sector and the result is limited to this sector. For the future research, there is a possibility to use another business sector such as service or trade industries as a sample. And it will enlarge the generability of the study. Moreover, related research in the future can use behavioral and entrepreneur life style instead as the independent variable that can predict in determining the variation SME's performance.

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## APPENDIX A

Characteristics	Frequency	Percentage (%)
<b>Proprietorship</b>		
Limited Company	51	27,7
Partnership	31	16,8
Personal	95	51,6
Cooperation	3	1,6
Other	4	2,2
<b>Total</b>	<b>184</b>	<b>100</b>
<b>Employee</b>		
<19	93	50,8
20-99	88	48,1
>99	2	1,1
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Starting the Business</b>		
Continuation from Parents	26	14,2
Started from the beginning	149	81,4
Buy	2	1,1
Other	6	3,3
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Capital</b>		
<10 Millions	94	51,4
10-50 Millions	42	22,9
51-100 Millions	24	13,1
>100 Millions	23	12,6
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Sources of capital</b>		
Saving	109	59,6
Borrowing	50	27,3
Other	24	13,1
<b>Total</b>	<b>183</b>	<b>100</b>
<b>Marketing Area</b>		
Local	111	60,7
Outside Province	24	13,1
Outside Region	37	20,2
Export	11	6,0
<b>Total</b>	<b>184</b>	<b>100</b>