

# Internal And External Environment Analysis On The Performance Of Small And Medium Industries (Smes) In Indonesia

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**Abstract:** The purpose of this study was to determine the influence of internal and external environment analysis on the performance of small and medium industries (SMEs) in Indonesia. The theoretical results showed that internal and external environment analysis have a significant effect on the performance of small and medium industries (SMEs) in Indonesia.

**Keywords:** External Environment, Internal Environment, Performance, Small Medium Enterprises (SMEs)

## 1. Introduction

Many countries around the world make the construction and development of Industrial Micro, Small and Medium Enterprises (IMKM) as one of the crucial driving force for economic growth of their country. One of the characteristics of the dynamics and good economic performance with high growth rates in the countries of East and Southeast Asia such as South Korea, Singapore, and Taiwan is a performance IMKM highly efficient, productive, and have a high level of competitiveness. Several countries of Africa region led to the development and growth of their IMKM to increase aggregate output and employment (Tambunan, 2009: 161). The existence of industrial Micro, Small, and Medium Enterprises is essential for the economic stability of a country (Lennox, 2013: 84). This industry has a role in facilitating the development of the global economy, because of this sector is seen to provide an important contribution in the transition to a market economy through the process of creativity, encourage the advancement of technology, organizational innovation, change, job creation, income generation, economic competitiveness, and other aspects of social development in general, and industrial expansion, in particular (Zamberi, 2012: 217-218). Small and Medium Industry commonly known as Small Medium Enterprises (SMEs) are significantly important role in promoting economic growth in many countries (Mahmood and Norshahafizah, 2013: 82), both in terms of employment and economic growth and development (Turner and Ledwith, 2009; European Commission, 2008). HPI also be important because it can maximize the allocation and distribution of resources by mobilizing and capitalize upon human resources and local materials (Cunningham & Rowley, 2007). Small and Medium Industries in Indonesia plays a major role in promoting economic growth (prime mover) for its ability to increase high added value. SMEs can also be an opportunity to create and expand employment, which means increasing the welfare and reduce poverty. With the amount of labor absorption in 2012 approximately 14 million people (including industrial micro, small, and medium enterprises), labor sector accounts for 12-13% of the total national workforce. Given the role of the industrial sector has a major role on the national economy, the development of industrial sector, especially the non-oil processing industry including craft industry become an important agenda. Furthermore, the development of Small and Medium Enterprises (SMEs) conducted by Presidential Decree No. 28 of 2008 on the National Industrial Policy.

There are 7 (seven) Cluster of small and medium industries IKM) yaitu: (1) snacks, (2) salt, (3) essential oil, (4) precious stones and jewelery, (5) pottery / ceramic ornament, (6) craft and art, and (7) fashion. Small industries in Indonesia are grouped in Micro, Small and Medium Enterprises (SMEs). This is in accordance with Law No. 20 Year 2008 on micro, small and medium-sized states that: "Small businesses are productive economic activities of its own, which is done by the individual or business entity that is not a subsidiary or not the branch company owned, controlled, or be a part either directly or indirectly, of a medium or large businesses that meet the criteria for small businesses. Based on the results of research conducted by Musran munizu (2010) that the performance of the small business sector is affected by two main factors namely the factors that exist in the external and internal environmental factors. Internal factors include aspects of HR (owners, managers, and employees), financial aspects, technical aspects of production, and marketing aspects. While external factors consist of government policy, socio-cultural and economic aspects, as well as the role of government institutions, universities, private and NGO (Haris Maupa, 2004). Furthermore, the results of crijins and Ooghi (2000) revealed that each stage of the company's growth is the result of two environments in which the company conducts its business, the internal and external environment. Important external environmental factors that affect the growth of the company is the industry and market, competitors and the economic climate. Where market-oriented company can respond to what is desired and needed by consumers, so as to satisfy the consumer and ultimately improve the performance of the company itself (Ramaseshan et al, 2002). Besides, the positive performance of the company is supported by a well functioning coordination between marketing and non-marketing activities (Ann Ledwith et.al, 2008). Success in improving the performance depends on the ability to manage both these factors through the analysis of environmental factors as well as the establishment and implementation of business strategies. This success will be achieved if their conformity between the internal environment and the external environment through the implementation and proper way. From the analysis of both the environment can be used as a basis for planning and determining corporate strategy, so companies can put themselves in a favorable position. This position will make the company able to compete and develop their business.

The company's strategy is a strategy developed in a business so that the company will compete by changing the distinctive competence into competitive advantage (Moses Hubeis, 2008). The company's strategy embodies three general orientation (which is often called the grand strategies): growth, stability, and reduction. Besides, there is also a competitive strategy is a business strategy (Competitive Strategy), which compete with its competitors to gain competitive advantage. Michael Porter introduced two generic competitive strategy to outperform other companies in a particular industry that is low cost and differentiation. Porter further said that the competitive advantage of companies in a given industry depends on its competitive range power. Key Opinions expressed by Longenecker, Moore, and Petty (2003: 33), is to achieve superior performance companies should make the process of external and internal environment analysis and determine the appropriate competitive strategy.

## 2. Review of Literature

### 2.1 External environment

The external environment is all events outside the company that has the potential to affect the company (Chuck Williams, 2001: 51). Many companies are now competing in a global market, not only in the domestic market. Changes in technology and increased ability to acquire and process information requires the implementation and competing responses are more timely and effective. Rapid sociological changes that occur in many countries affects employment, in addition to the desired product properties consumers increasingly varied. Policies and laws that affect the government outlined the company's choice of where and how they will try and compete. Companies should be alert and aware of the impact of the reality of this environment, so it can be an effective actor in the global economy. In organizations that compete strategically, the owner / manager of the company will look for patterns that can help them understand their external environment, and this may be different from what they expected. It is important for decision makers to have an understanding of the competitive position of the company and accurately. Decision-makers in SMEs, in this case the owners / managers of SMEs should be aware that the knowledge of their corporate environment will help in improving the competitive position of the company, improve operating efficiency, as well as winning the battle in the global economy Ireland, Hoskisson and Hitt (2011). Thomas L. Wheelen and J. David Hunger (2012: 146), the external environment divides into two, namely the social environment (Sociaetal environment), and the work environment (Task environment). Social environment including general powers that are not directly related to the activity-activity organization short term but can and often can affect the long-term decisions, these include: (1) economic forces that govern the exchange of materials, money, energy, and information; (2) The power of the technology, which resulted in the discovery of problem solving; (3) The Power of Political Law, which allocates power and provide coercion and protection laws and rules; (4) The power of Sociocultural that set the values, traditions and customs of indigenous environment. Work environment, including the elements or groups that directly and in turn will

be influenced by the company. The group consists of government, local communities, suppliers, competitors, customers, creditors, labor, special interest groups and trade associations. Ireland, Hoskisson and Hitt (2011: 33), the external environment divides into three main components, namely, the general environment, industrial environment, and the competitive environment. General environment includes elements within the wider community that can affect an industry and the companies in it. These elements are grouped into seven segments environment consisting of segments of demographic, economic, political / legal, socio-cultural, and technological, global, and physical. Industrial environment is a group of factors threat influx of newcomers, power suppliers, power of buyers, threat of substitute products, and intensity of competition among competitors that affect a company and move as well as competing responses. As for how companies collect and interpret information about their competitors called the competitor analysis. Meanwhile, according to Pearce and Robinson (2013: 87), external environment consists of a remote environment, industrial environment, and the operating environment. Dess, Lumpkin, and Taylor (2012: 79), said that the company's external environment is classified into two, namely the general environment, which consists of population demographics, socio-cultural, political and legal, technological, economic; and competitive environment, which consists of the power purchaser, provider (supplier), the threat of new entrants, threat of substitute products, and intensity of competition in the same industry. While Thomson, Strickland and Gamble (2010: 57), dividing the external environment into two, namely the macro environment (macro environment), including economic conditions, population demographics, technology, social values and lifestyles, the regulations; environmental and industry / competitive (industry and competitive environment), including suppliers, customers, competitors, new entrants, substitute products. But for small and medium industries (SMEs) in the opinion of Julieta Ojeda-Gomez., Et al (2007: 290), the external environment consists of the macro environment and micro environment, which both affect the performance of SMEs. Macro environment, including in this case include the socio-cultural, political, technological, demographic, and economic. While the microenvironment of the actors involved directly with the company and also affect the company, consisting of suppliers, customers, Intermediary Agent, government institutions, competitors Julia Ojeda-Gomez., Et al (2007: 290). As with the opinion of Musran Munizu (2010: 34) for SMEs, which includes the external environmental factors including government policies, socio-cultural, economic, and the role of institutions such as governments, universities, private sector, and NGOs. While Popy Rufaidah (2012: 109) explains that the external environment consists of macro and micro environment. Macro environment is often referred to as a remote environment or remote environments, while the microenvironment called environmental task. Macro environment consists of factors that are difficult to control because it is beyond the reach of the company's management is often abbreviated with PEST (Politics, Economics, Social and cultural, and Technology). For components microenvironment consists of customers,

competitors, suppliers (collaborators), and lenders (creditors).

## 2.2 Internal environment

The internal environment according to Moses Hubeis and Mukhamad Najib (2008: 32) is a corporate environment that is in the organization and normally have a direct and specific implications on the company. Owners / managers of companies should look into the company to identify internal strategic factors, namely the strengths and weaknesses that will determine whether the company is able to take advantage of existing opportunities while avoiding threats. There are many opinions on how a company in analyzing the internal environment. According to (Pearce and Robinson, 2013; Ireland, Hoskinson, and Hitt: 2011; Jay B Barney., Et al: 2010; Thomson & Strickland: 2010), the analysis of the company's internal environment includes the resources, capabilities and competencies held by the company, this is known to approach Resource Based View (RBV). In the RBV approach that the resources owned by the company is far more important than the structure of the industry in gaining and sustaining competitive advantage. According to the RBV approach, the main concern is a firm resources and capabilities. Pearce and Robinson (2013: 164), divides the resources into 3 (three), namely: (1) Assets are visible (tangible assets) include production facilities, raw materials, financial resources, and computers; (2) invisible assets (intangible assets) are included in the brand, reputation, moral enterprise, technical knowledge, patents, trademarks, and accumulated experience of a company; (3) Capability organization, the skills and the ability of combining assets, people, and processes that can be used by companies to transform inputs into outputs. Another great way to analyze the strengths and weaknesses of an organization. In this case the management theory describes how an organization check keuatan and weaknesses. Peters and Waterman created the concept of the seven S framework for analyzing the strengths and weaknesses of the company. While Porter introduced an internal analysis method known as value chain analysis (value chain). Although there are many ways to analyze the internal environment, the simplest way to observe and analyze the internal environment is through functional analysis (Thomas L. Wheelen & J David Hunger, 2012: 195). H.I. Ansoff, argued that the expertise and resources of the company can be set to the appropriate competency profile business functions such as marketing, finance, research and development, operations, human resources, information systems and corporate culture. Which includes internal factors according Musram Munizu (2010) which aspects of HR (managers and employees); financial aspects; technical aspects of production; and marketing aspects. Based on the above research background, and the object of study is the small and medium enterprises (SME) sector of the craft, the dimensions of the internal environment that are relevant to this research, including marketing, finance, operations, human resources, and information systems.

### 1) Marketing

Fred A David (2011; 135), described as the process of defining marketing, anticipate, and meet the needs and desires of customers for goods and services. Fred

explained that there are seven basic functions of marketing: (1) analysis of the customer, (2) the sale of products / services, (3) planning products and services, (4) pricing, (5) distribution, (6) marketing research, and (7 ) analysis of opportunities. Understanding these functions help develop strategies to identify and evaluate the strengths and weaknesses of marketing. However, according to Kotler (2009) defines marketing is seen as a task to create, introduce and deliver goods and services to consumers and other companies. In this case Kotler explains the marketing concept consists of four pillars: the target market, customer needs, integrated marketing / integrated, and the ability to generate profits. But according to Hitt Ireland & Hoskisson (2003), that is the marketing activities undertaken to provide the means to be used by consumers to buy products and encourage them to make a purchase

### (2) Financial

Financial condition is considered as one the best size for the competitive position and the overall attractiveness of a company. Determine the strengths and weaknesses of an organization's finances is essential in order to formulate effective strategies (Fred R David, 2011: 139). According to James Van Horne, the function of finance / accounting consists of three decisions: investment, financing decisions (financing), and dividend decisions. Investment decisions, also known as capital budgeting (capital budgeting), is the allocation and realization of capital and resources to the project, product, asset, and the division of an organization. Funding decisions determining the best capital structure for the company and includes the evaluation of the various methods that can be used by companies to generate capital (for example, by issuing shares, increasing debt, sell assets, or a combination of these approaches). Dividend decisions thinking about issues such as the percentage of earnings paid to shareholders, dividends paid stability over time, and the repurchase or the issuance of shares. In the case of SMEs, the dividend decision in this case is how much profit to be earned by the business owner, if all the operating income is used for the personal use or profit pemiki in use as additional capital.

### (3) Operations / Production

Operation is an important activity to convert the input provided by the logistics into the final product form (Hitt Ireland & Hoskisson; 2011: 73). The use of machines, packing, combine, and maintenance of equipment are examples of operating activities. Production function / operation of a business consists of all activities that transform inputs into goods and services (Fred R David, 2011: 145). Management of production / operations associated with the input, transformation, and output that varies among industries and markets. Manufacturing operations to change or transform inputs such as raw materials, labor, capital, machinery, and facilities into finished goods and services. Production activities / operations often represent the largest portion of the assets of human resources and organizational capital. In most industries, the largest cost in the production of a product or service occurs in operation, thus production / operations can have great value as a competitive tool in the overall strategy of the company.

#### (4) Human Resources (HR)

One of the company's internal factors are the most important human resources (workers and employers / owners) in accordance with the opinion (T.Tambunan, 2009: 97), because the workers and employers have the skills / higher education then caused the company has high competitiveness. Skill labor / workers in production techniques (eg product design and production processes), but also marketing techniques as well as research and development. While the skills employers are primarily business insight, and are referred to here is the insight about the business that they do and the external environment. Many literature suggests that many factors that determine the ability of SMEs to innovate, including the creativity of entrepreneurs, and the latter, in turn, is determined by the insights about the business is practiced (Shahid, 2007). In achieving competitive advantage, companies need a leader who can be a visionary, innovative, and entrepreneurial; especially for small and medium enterprises (Fernald et al, 2005), where IKM requires expertise as a leader who has the following characteristics: (1) View and clearly communicate the direction in the future; (2) lead and motivate; (3) Knowing and compensate for the shortcomings in the team; (4) have the business skills through eukasi process and of the experience gained.

#### (5) Information Systems

Information systems not only can help in environmental monitoring and control of the various activities of the company, but also can serve as a strategic weapon in the effort to gain a competitive advantage (Thomas L.Wheelen & J.David Hunger, 2012: 210). Furthermore Hunger explain the purpose of the information system, namely: (1) to give a warning signal issues both from outside and inside the company; (2) The information system can automate clerical operations, such as payroll, inventory reports etc; (3) The information system can help managers / owners to make decisions. According anatan and Ellitan (2009: 20) in a study in which the ability to master the information and knowledge is an important factor in explaining the competitive advantage and firm performance. It is also the same as the opinion of T.Tambunan (2009: 96), in which a company's competitiveness is determined by one factor is the availability of information. While Cravens (2009) explains that the information system provides an important technological advantage, many organizations are not able to use it fully. The information system will be important in the future, linking inter-organizational cooperation, suppliers, and consumers.

#### 2.3 Small Industry Performance

Jones (2004) says that companies must constantly change to develop its effectiveness. Perusahaan is intended to find or develop a way to use existing resources and capabilities to enhance the ability to create value and improve performance. Performance is meant here is not the performance in the narrow sense that only limited to financial gain. Indeed, the advantage of course have to be hunted, because without profit companies will not be able to survive, but the goal of the company is intended to maintain the survival and durable. At first it only financial criteria used to assess whether or not the superior performance of

a company. Performance serves as an instrument to determine whether the company has the ability to sustain life (going concern), as well as a basis for formulating operational planning company in the future and for the information of shareholders, stakeholders, customers, regarding the achievements and success of the company. There are many approaches, in defining the performance, according to Mulyadi (2007: 337) is the successful performance of personnel, team, or organizational unit in achieving the strategic objectives that have been set previously with the expected behavior". Mulyadi also explained that the successful achievement of strategic objectives needs to be measured. That is why the strategic objectives that form the basis of performance measurement is necessary to determine its size, and determined strategic initiatives to realize these goals. Achievement of an organization is only possible because of the efforts of the actors that exist in the organization. In the literature, there are two approaches to measuring the performance advantages of the company (Supratikno et al, 2005). The first approach stated that the superior performance of the company called if it has performed above average (above average performance) is viewed from a variety of dimensions, such as market share, financial kineja, etc. The second approach assesses corporate excellence implied from the age of the company (corporate longevity). Companies that age long, which means it can survive for a long time, is a company whose performance is superior. The development of further stated that the overall performance can be measured by five indicators, namely financial indicators, indicators of growth, cash flow indicator, the indicator value, and the stock price indicator. However, according to Chong H.Gin in the Journal of Business, Measuring the performance of small-and medium-sized enterprises: the grounded theory approach (2008: 1-4), said that in order to measure the performance of SMEs using the hybrid approach is a combination of financial and non-financial measurements.

### 3. Theoretical Framework

#### Environment External Relations and Corporate Performance

The following discussion is about the External Environment influence on company performance derived from the results of empirical research conducted by Musram Munizu (2010: 33), states that the performance of the micro and small enterprise sector is affected by two main factors namely the external environment and internal environment. The internal environment includes aspects of HR (owner, manajerm and employees); financial aspects, technical aspects of production; and marketing aspects. While the external environment is composed of government policies, socio-cultural and economic aspects, as well as the role of institutions such as governments, universities, private sector and NGOs. Based on research conducted by Crijins and Ooghi (2000) revealed that each stage of the company's growth is the result of two environments in which the company conducts its business, the internal environment and the external environment. External environmental factors that affect the growth of the company is an important industry and market, competitor, and the economic climate. While the internal environmental factors

that are critical to the growth of the company is small entrepreneurs as managers, the company as an organization, ownership or ownership structure. While the research results Wisardja (2000) showed that industrial environmental factors whose elements are customers, suppliers, competitors, and technology has a significant impact on the success of the wood carving industry in Gianyar, Bali province; and elements of the most dominant influence customers to the success of the timber business. In connection with environmental aspects. The environment can be defined as a source of events and changes which can bring opportunities and threats for the company (Lenz, 1978: 32), quoted by Julieta Ojeda-Gomez, Mike Simpson, SCLenny Koh and Jo Padmore (2007: 289). research explains that the external environment consists of the macro environment and micro environment that greatly affect the performance of the company. Microenvironment is the actors involved directly and related companies, including suppliers, customers, realtors, government institutions, competitors. While the macro environment changes occur regarding social, economic, political, technological, demografii, and culture. There are two factors that make environmental analysis is important and should always be done by every manager of the company, namely: (1) That the company does not stand alone, but interact with a part of the environment and the environment itself is always changing all the time, (2) The effect of a very complex environment and the complex can affect the performance of a company (Imam Suryono, 2007). The success of a company depends on the ability to manage both the environmental factors both external environment and internal environment, through the analysis of environmental factors as well as the establishment and implementation of business strategies. Many studies that explain the relationship between environmental influences on the performance of the company, including the results of a study of Ramaseshan et al (2002); Kohli and Jaworski (1990) cited by ledwith and Michele Ann O'Dwyer (2008: 96) states that the market-oriented company, so it can respond to what the needs and desires of customers, it will be in satisfying consumers, so as to improve performance companies such as ROI, profit, sales, market share and sales growth. Brown et al (2005) found that by implementing the orientation of the market will improve marketing performance and financial performance. While Di Benedetto (1999) explains that the positive performance of the company is supported by coordination between functions, which increase the effectiveness of marketing activities and the activities of non-marketing.

#### **Internal Environmental Relations and Corporate Performance.**

Study Musram munizu (2010) on the influence of external factors and internal to the performance of micro and small enterprises in South Sulawesi found that factors external environment which consists of aspects of government policy, socio-cultural and economic mempenyai that significant and positive influence on the internal factors contributing by 98%. Internal factors which consists of aspects of human resources, finance, production, and marketing has a significant and positive effect on the performance of SMEs amounted to 79.2%. Each company must define and execute business strategies to best suit the

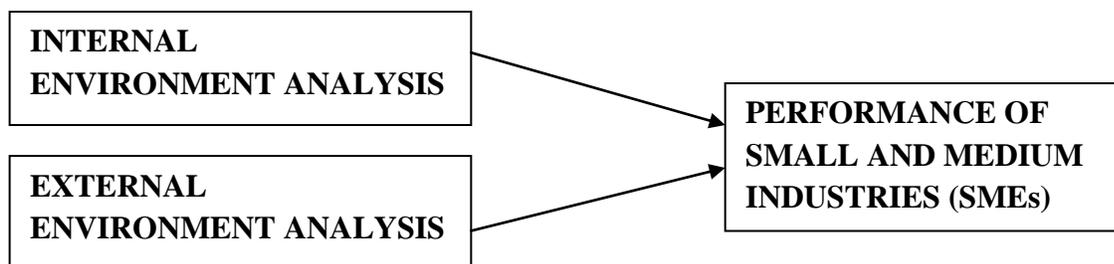
company's internal capabilities in the face of competition. Several alternative business strategies that can be developed by a company is a competitive strategy and strategic partnerships. competitive strategy which is a research variable here refers to the opinion of Thomson, Strickland and Gamble (2010), which includes the cost leadership strategy (cost leadership), the strategy of differentiation, costing the best strategy, focus strategy costs (cost focus ), and differentiation focus strategy. While the partnership strategy, which is also a reference to the research variables Hao Ma (2004), namely: Setting foothold, pooling resources and sharing risks, sharing complementary resources and skills, learning from partners, bulding alliances, weighing options in multiple alliances . Competition is increasingly competitive requires companies to have a competitive advantage in order to win the competition and get the market and opportunities. To anticipate the company will need to develop a competitive strategy that focuses on core competencies both in terms of price, quality, flexibility, and delivery. To improve the performance can be obtained by applying one of the competitive strategy by a company, as expressed by Porter (2004), which argues that if a company can achieve and maintain overall cost advantage, then the company will be the companies that perform above average in the industry. Companies that can achieve and maintain differentiation will be performing above average in the industry and if the company can achieve sustainable cost advantage (cost focus) or differentiation (differentiation focus) in its segment and the segment is structurally attractive, the adherents of the strategy focus will be performing companies above the average in the industry. Meanwhile, in the opinion of Longenecker, Moore and Petty (2003: 33), stated that in order to achieve superior performance, the company should make the process of analyzing the external and internal environment and determine the appropriate competitive strategy. The study conducted by Badri et.al (2000), where he tested the effect of environment on the choice of strategy and corporate performance, and the results showed that companies with high performance will adjust the complexity of the external environment by using environment variables as a source of effective control within the company. The existence of fundamental changes in the global economy such as the increasingly intense competition, rapid technological development, increased development costs, production costs and marketing costs of new products, to compete in the arena, any company could not bear the fixed costs are so great. In turn required business partner (partner). Strategic partnerships between organizations (both governmental and private) aims for the following reasons, to give way into the market, reducing the risk caused by changes in the environment, the ability to complement each other, and to obtain resources outside of which can be produced by a company. Partnerships become important because of the complexity and environmental risks in the world economy, as well as the limited capabilities and resources of a company. Studies conducted by Herrera (2002), shows that the cooperation in the foster parent program was instrumental in raising achievement and SMEs can improve their business conditions. Meanwhile, according Ellitan (2009: 201), that the companies involved in the partnership can benefit through the creation of improvement and development on

such things as access to research and new discoveries that can help companies to develop new processes and products. Based on the above, so that it can be described causality external and internal environment of the partnership strategy and its impact on competitive advantage and performance. Measurement of performance required by any company whether they are profit oriented, and non-profit oriented. This is due to the measurement results will be useful as a basis for planning. Besides, companies are becoming more aware of the strengths, weaknesses, opportunities and challenges facing it, and can also see the critical factors that require immediate response. In this study, the authors measured the

performance of SMEs refers to the concept of H Gin Chong (2008) and Ann Ledwith (2008), which measures the performance by using a measurement of financial and non-financial measurements. Measurements with finance, including turnover, net profit before tax, return on investment, growth in revenue, growth in number of employees. While non-financial measurements include referrals customers, employees turnover and market share.

#### 4. Study Model and Hypothesis

Based on the theoretical framework have just described, then the theoretical framework is as below:



*Figure 1 : Theoretical framework of this study*

This study is aimed to determine the causal relationships between variables through hypothesis :

**Hypothesis 1:** The performance of small and medium industries (SMEs) influence by internal environment analysis.

**Hypothesis 2:** The performance of small and medium industries (SMEs) influence by external environment analysis.

#### 5. Methodology and Finding

This study is a theoretical study of the influence internal and external analysis on the performance of small and medium industries (SMEs) which employed the secondary source of data collection by making use of available literature on internal and external analysis on the performance of small and medium industries (SMEs). In hypothesis testing, providing theoretical evidence that there is asignificant relationship between internal and external analysis on the performance of small and medium industries (SMEs).

#### 6. Conclusion

Internal and external analysis effects on the performance of small and medium industries (SMEs). The theories that already exist about management and organization make more emphasized linkages, that the influence internal and external analysis on on the performance of small and medium industries (SMEs). The results of the theoretical evidence from this study can be used to solve problems that occurs on on the performance of small and medium industries (SMEs). The performance of small and medium industries (SMEs) can be improved through increases in internal and external analysis.

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