FIRM-LEVEL COMPETITIVENESS IMPROVEMENT

LESSONS FROM SENADA'S ENTERPRISE IMPROVEMENT (EI) PROGRAM

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EXECUTIVE SUMMARY

The implementation of SENADA's Enterprise Improvement (EI) program suggests various issues at firm-level that are relevant for shaping the competitiveness of small and medium firms in Indonesia. At the risk of oversimplifying, this study lists and discusses some of these issues or problems, and attempt to derive some lessons that we can learn from the EI program.

Problems related to finance substantially hold back firms from improving their competitiveness. The study finds four specific problems. First, most of small and medium firms do not have financial documentation. Particularly, they do not have basic financial reporting and procedure, financial reports, and accounting knowledge. The extent of this problem is quite large, that is, about 90 per cent of SENADA clients do not have any kind of accounting or book-keeping system.

The second problem is the inability of the firms in computing Cost of Good Sold (COGS). The inability to compute overhead cost and to assign per-unit cost to per-unit of output produced are the core of the problem. The inability results in the lack of awareness of whether the price of output is over- or under-price. To some extent, this leads to a rather low bargaining power of the firms when executing transaction with buyers, particularly those of wholesale buyers.

The third problem is a weak working capital management. Here, firms seldom take some actions that could increase the amount of 'fresh cash' held by firms at any time. In principle, these actions are those which are able to increase the collection rate of receivables or/and improving the production-and-logistic system. The latter is particularly aimed for having an effective use of raw materials.

The last problem concerns with the access to finance for small and medium firms. In the perspective of the firms, the core of the problem is the fact that most firms are not bankable. There are several reasons for this, including inability to meet the 'tough' requirements needed by banks and the fact that some sectors are listed in the banks' negative list for loan recipients. Equally important, some banks adopt the pr esumption that small and medium firms are simply lack of capability and capacity to undertake professional business operation.

However, there is an impression that some firms in Indonesia, or at least some SENADA's clients, do not really consider the lack of access to bank as an important problem. In practice, they often resort to other source of financing which, unfortunately, charge higher cost of capital. It is interesting to note that these firms are actually aware of the more expensive cost of capital despite their preference to the alternative source. Therefore, these firms consider the cost for having a more expensive loan is actually still lot cheaper than the transaction costs they need to pay for acquiring business loans from banks.

Some problems hinder the potential to gain from exporting. Two of the most important ones are weak design specification and the lack of knowledge for conducting exporting activities. The former might have something to do with the fact that some firms only perform what so-called 'cutting-making-and-trimming' activities (CMT). Thus, there has never been any experience for these firms to conduct their own product development. As for the latter, the core of the problem is the lack of understanding of firms' managers on mechanisms, procedures, or strategic actions that related to exporting activities. Related to this is the incapability to execute a success trade fair participation.

A related point but not necessarily a problem concerns the role of export agents. The key point is that the agents help inexperience firms in facilitating and penetrating export markets. However, this

positive role of agents could backfire those who have some experience in international markets. This is because the agents for some reasons could switch export-orders from one to another company.

The problems to penetrate export markets represent a broader marketing issue. Most firms conduct only minimal marketing strategy. More specifically in the context of domestic market, this could be the result of strong dependency of firms to the agents/traders who buy their products. The study finds this strong relationship in almost all sectors covered by SENADA. Ideally, this problem can be solved by widen the market. However, this is also problematic because managers are also lacking from proper marketing skills.

Weak attention to the importance of the management in inventory and production characterizes operation of most small and medium firms. Specific problems include, for example, the absence of documentation for the flow of raw materials, unorganized warehousing system, and the absence of system for handling production plan. All these increase inefficiency. There is often a 'lumpy' production process where machines are often switched-off due to lack of raw materials and a high level of defective rate due to lack of control during production process.

This study also found that most small and medium firms operate with a strong characteristic of family-run business. A strong top-down (i.e., from owners to managers) is so apparent in the management style of these firms, creating quite frequent conflict of interest between owners and managers. This study finds that the strong top-down approach could actually be effective. However, it seems to only occur when the owners are visionary and highly educated.

The EI program offers some lessons to improve competitiveness. Among other, capacity building to improve the adoption of modern management knowledge is clearly needed. As elaborated in the report, it appears that the weak company's performance is often rooted in the absence some modern management practices, such as system procedure, financial system, and marketing strategy. Another important lesson is that, there is a need to develop an idea for providing small and medium firms with more alternatives of external financing. All in all, the program provides support for paying attention to the issues at firm-level. This is important because many observers believe that firms' competitiveness is considerably affected by policies or issues at either industry or national level.

1. INTRODUCTION

1.1. OBJECTIVE OF THE REPORT

Ability to stay competitive in markets determines the extent of performance and survival of a company. Achieving it, however, is not an easy task. SENADA launched its Enterprise Improvement (EI) program in 2006, which provides close assistantship for some firms in Indonesia and aims at improving the firms' competitiveness. The program was based in an underlying principle that firms' competitiveness is affected not only by some external factors (e.g. government policy and global market situation), but also by some internal factors.

This study builds upon the EI program and aims at deriving some lessons learnt from the EI activities. It documents and discusses the constraints faced by the firms assisted by SENADA. It focuses on firm-level constraints which can be categorized as the following according to the subjects of the constraints: finance and access to finance, export promotion, operation and logistics, marketing and organisational issues. The categorization obviously does not capture all kind of internal firm-level problem. Time and resource limitation of this study, unfortunately, does not allow the author to further continue the exploration of the problems. Nonetheless, interviews conducted by the author with SENADA's experts indicate the subject above represent the most important problems faced by firms.

Firms assisted by SENADA – or often expressed interchangeably as 'clients' in this report – are firms that operate in the following industry: automotive parts and components, footwear, garments, furniture, and information-and-technology. The clients are distributed across different locations in Indonesia. The distribution, however, is rather unevenly. For example, clients taken care by Surabaya regional office are concentrated in garments and footwear industry, while the clients of Semarang regional office are mostly furniture producers – mainly located in the Jepara furniture cluster and Solo. Almost all of the clients are small and medium in terms of size, measured by nominal value of annual sales. The uneven distribution, to some extent, proposes a great variation across firms in terms of the extent of the problem. However, the interviews does not indicate so, albeit few obvious difference (e.g. few constraints that uniquely attach to furniture producers in Jepara).

1.2. METHODOLOGY AND STRUCTURE OF THE REPORT

This study adopts a qualitative approach. This is conducted by documenting, deriving, and discussing the firm-level constraints from the results of interviews with SENADA's experts in all of its offices (SENADA has four offices in Indonesia: Jakarta, Bandung, Semarang, and Surabaya. The office in Jakarta is the head office while the rest are regional offices). The interviews were conducted within a number of days in June and July 2007.

While useful, interview method has some weaknesses. The most important one, perhaps, is the subjectivity of the arguments or information derived from the interviews. Therefore, it is important to bear this limitation in mind when interpreting the findings. Particularly to this study, the extent of subjectivity could even be high, because the clients represent only a very small subset of all firms in Indonesia.

As a way to provide an an effective presentation, this report firstly presents the lessons learnt from the EI program – given in Section 2 – before presenting the more detailed findings of the interviews, from which the lessons learnt were derived. These findings are presented in Section 3.

2. EI LESSONS LEARNED

This section provides some insights into the lessons that we can be gained from the EI program. These are presented below, based on the findings elaborated in Section 3.

- Firm-level constraints do matter in determining firms' competitiveness. Specific problems often occur across the clients despite differences in business activities and locations. For example, inability to properly compute COGS is not only experienced by firms in furniture cluster of Jepara, but also by footwear producers in Bandung region. Thus, in short, this report supports the proposition that underlie the existence of the EI program.

- Problems related to financial management substantially hold back many SMEs. The key issue is that almost all small and medium firms do not have a proper financial reporting system. Because of this, these firms are unable to take some strategic actions to improve their competitiveness and performance. In most cases, strategic actions are taken only on 'ad-hoc' basis without much information from the real financial situation.

- Access to finance is another issue for many small and medium firms. Small and medium firms are simply unable to meet the requirements set out by banks or, in other words, these firms are not bankable. This situation, in turn, makes the activities to meet all requirements needed by banks as a costly activity for the firms, and this is not to mention the additional costs and charges the firms need to pay if they were to acquire loans from banks, which is about 1.5 per cent of the total amount of the loan.

  It is worth mentioning here that Post Dated Cheque (PDC) plays a significant role for providing working capital for small and medium firms. While there is a variation in the extent of the significance across firms and sectors, it is suggested that PDC contribute for about 50 to 75 per cent of the total amount of working capital needed by a firm.

- It is still not clear which approach should be taken to improve access to finance for small and medium firms. On one hand, the findings suggest that high transaction cost for acquiring loans renders the firms to resorts to alternative source of funds, which is actually offer relatively higher price compared to loans. The findings indicate, however, that some firms do not seem to consider this as a significant constraint. On the other hand, it seems a quite difficult process – if not impossible – to make the firms bankable, (i.e., eligible for asking loans).

  The point to make here is that, small and medium firms do not seem to complain on the high price charged by the alternative external finance, and hence it can be considered as an equilibrium situation. In other words, loans for business operation provided by banks are relevant with or can be given only for larger firms. The broad conclusion does not imply that the idea of developing some new other alternative financing sources, which can offer cheaper cost of fund compared to the other traditional alternative sources, is not reasonable. In fact, the idea is so relevant given the point made above.

- Small and medium firms can considerably improve their performance by exporting, provided that they make effort to thoroughly prepare their participation in trade fairs and enhanced their knowledge on exporting activities. Few success stories documented in *Case Study 3* suggest this.

  It remains to be seen, however, that small and medium firms can sustain their participation in selling to global market. This is illustrated in an experience of a client where traditional, or sometimes ad-hoc, management style adopted by this firm forbids the management to maintain relationships with international buyers or updating some changes regarding exporting procedures (see *Case Study 3*). Rarely noted, this is actually a 'big' lost for the firm. As noted, starting to export is a very costly activity. Therefore, any successful action in establishing export should be maintained. This way the firms can always ensure their favourable performance and survival chance, because firms can always to revert to one of their market – i.e., domestic or international – should there any shocks that disturb one of the markets.

- Capacity building activities are needed to improve managerial skills. This is important to encourage firms to adopt modern management practices. As discussed, this is highlighted by the fact that weak company performance is often rooted in the absence of proper management system. For example, many firms do not have proper financial reporting system and marketing strategies. A caveat applies here, however. The capacity-building activities should be catered in such a way to meet the most likely unique problems faced by small and medium firms.

- Most small and medium size firms in Indonesia tend to be family-run business operations. While it is debatable regarding the pros and cons of family-business style, the findings suggest that the family-business style seems to underlie some problems in small and medium firms. What needs to be reiterated, perhaps, is the fact that in some cases family-business style is actually effective to have some internal-management reforms done. Therefore, one relevant practical implication for the future is to identify the factors that determine a successful family-run business.

3. FIRM-LEVEL CONSTRAINTS: KEY FINDINGS

3.1. FINANCE AND ACCESS TO FINANCE

Almost all of the interviews conducted by the author indicated that problems related to financing significantly hold companies back from improving their competitiveness and performance. At the risk of oversimplification, we can specify four specific problems, each of which is discussed below.

3.1.1. FINANCIAL REPORTING

Companies simply do not have financial reports. This problem, however, typically occur in small-scale firms. More specifically, these firms do not have:

- Basic financial reporting and procedure, notably balance-sheet and income-statement,
- Financial tools, both the computerized and non-computerized (i.e., some hard-copy firms for accounting purposes), and
- Sufficient finance and accounting knowledge.

SENADA clients do not have any kind of book-keeping and/or accounting-recording system. The financial-recording system often used by the clients is a very simple cash-book. Even when the clients have it, they often have only the non-systematic cash-book system, which less likely to provide useful information they need.

Regarding the insufficient financial knowledge, almost all managers of the client understand and acknowledge the importance of financial management for the purpose of measuring and monitoring company's performance. However, most of these managers do not understand the detailed procedure and methodology for collecting financial data and for creating systematic financial reports.

The immediate impact of having no financial reporting is clear, and that is, firms are unable to take strategic actions to improve their performance. This is because firms do not have some kind of proper internal guidance, which is supposedly provided by the financial reports. In most cases, financially related decisions are taken only on 'ad-hoc' basis, and the decisions are sometimes taken even without some knowledge on the real financial situation. For example, firms often end up with uncontrollable receivables which, to some extent, lower their capability to raise cash to pay the amount of working capital they need.

In responding to this problem, SENADA assisted firms to create their own financial system and tools. This system aligns with the standard code and conduct set by the Association of Indonesian Accountants (*Ikatan Akuntan Indonesia, IAI*).

Different to those in theory, the assistance directs firms to create the most flexible and simplest financial system – instead of a complex but formal financial system. This is due to the limited human and capital resource owned by the firms. In practice, the flexible financial system 'bypasses' some steps for a production of financial reports (i.e. balance sheet and income statement). As for the financial tools, SENADA created manuals for non-computerized tools.

It is worth mentioning the pros and cons of the more flexible system. The pros, obviously it avoids complexity, and this is actually very suitable for SENADA's clients which concentrate more in small and medium firms. Managers of the clients often complain that they would be better of using the time they have to seriously run the company instead of using it to produce a proper financial report. As for the cons, the purpose of the more flexible and simpler report is of course limited. However, the limitation is acceptable as long as the reports are able to measure sales, profit (or loss), and costs. These are the minimum requirement of information should be extracted from financial reports.

3.1.2. Cost Of Good Sold (COGS)

Firms are either unable to correctly compute COGS or having no method for calculating COGS. This can be elaborated into three more specific problems (see Case Study 1 for a more detailed exposition in this issue):

- Firms fail to take into account unobservable overhead costs (e.g. cost for electricity, transportation, etc.). Here, most firms only take into account the observable overhead-cost components, which are dominated by the cost of raw materials and labour,
- The inability of the companies to allocate per-unit overhead cost to per-unit output nominal value, and
- Firms often fail to predict the variation in the amount of production and overhead costs, and firms do not include the extent of this variation in their per-unit output value. Firms usually predict beforehand the amount of the per-unit cost as an ideal or a benchmark for valuing a unit output produce. The variation could occur because of, for example, some defected raw materials. In this case the company needs to buy another set of raw materials for replacing the defected ones.

There is some variation in the extent of the problems across firms. For example, all these problems occur in most of small companies, but the failure to take into account the unobservable overhead costs only occur mostly in medium and larger firms.

The point to make is that, the inability to compute COGS results in either under- or over-pricing of each produced output, which then can undermine the companies' survival and competitiveness (see Case Study 1 for an illustration of this issue).

In responding to the problem, SENADA provide trainings of calculating COGS. To be effectively absorbed by firms, SENADA trained firms to be able to compute COGS within the 'job-order costing' framework. This means that the COGS calculation is done for every job-order. This is different to the other approaches (i.e., 'process costing' and activity-based costing' approach) which calculates COGS according to the stages or group of activities in production. The choice of the framework (i.e., 'job-order costing' approach) was based on casual observation that firms determine the price of their product according to work-order they receive.

Case Study 1: COGS

A complaint by a SENADA's client for getting only very low profit revenue despite significantly sales revenue highlights the issue company's inability to properly compute COGS.[1] An examination by SENADA's expert revealed two major weaknesses in the company's cost computation.

The first is the inadequate warehouse documentation. Because of this, the finance manager was not able to determine the value of raw-materials and other intermediate should be assigned to the value of per-unit good produced.

Case Study 1: COGS – continued.

The second weakness is the absence of documentation of labour's man-hours of work used during production. The finance manager was not able to assigned per-unit of labour cost into the per-unit cost of the goods produced. The absence of documentation on the employment also does not allow managers to monitor performance of the labour (i.e. labour productivity). In addition, it was revealed there was no proper general accounting documentation. Therefore, there the exact value of per-unit overhead costs was also not available.

All in all, it is clear of why the company was not able to generate reasonable profit from its high sales revenue. The weakness in documentation of the major components of production cost does not allow the company to sets its unit price, and hence does not allow the company to determine whether the price it charges cover all production costs. A further examination revealed that most of the time the goods sold by the company had been significantly under-priced and this explains plainly of why the company earned only very low profit, albeit strong sales growth.

It is worth mentioning a hypothesis on a deeper negative impact of inability of a company to properly compute COGS. The impact is at industry level (i.e. affecting a particular industry) but seems to only apply when there is a high degree of proximity in terms of location. The hypothesis is derived from the experience of producers in Jepara's furniture cluster. In particular, the lack of knowledge on cost structures renders the furniture producers with a very weak bargaining power when they have to trade with export agents (or traders).

In other words, the producers do not have market power in setting the price. The extent of this problem is worsened by a strong price competition between firms in the cluster. While this might be an optimal solution from economic point of view, it could be a disappointing result from the producers' perspective. They could be losing much of the value added from producing a highly differentiated furniture product, which is one the characteristics of the Jepara's furniture cluster. This is because the retail price are likely be set at much higher price than the mass-produced furniture products.

3.1.3 WORKING CAPITAL MANAGEMENT

Many SENADA clients do not seem to have good working capital management. A good working capital management – defined broadly as an integrated action of maximizing receivables and minimizing inventory and payables – is crucial for a strong growth performance. The so-called "free" cash flow generated from good working-capital management allows company to boost their financial performance, either by cutting their cost of capital (i.e. by reducing their debts) or by using the cash to invest or perform business expansion. These mechanisms should increase the extent of profit margin from every unit good sold.

In the subject of corporate finance, a good working capital management is one of the possible strategic actions suggested by the Economic Value Added (EVA) approach. The approach postulates that firms should not focus only on maximizing profit, but also on minimizing capital-cost charged by firm's business activities. All these have an objective of increasing the value of firms, and hence economic return for the shareholders.

The problem with the clients, and most likely with many other firms in Indonesia, is that they focus only on how firms increase sales and/or profit, without some serious attempt to increase the free cash-flow from the elements of working capital. Therefore, from the perspective of EVA approach, the real value of a firm often does not increase albeit a very high profit margin or sales value.

Case Study 2 illustrates the importance of working capital management, using some financial data of few SENADA's clients. It is shown that a moderate attempt to improve the performance of working capital elements should be able to generate significant amount of cash-flow. It is important to highlight here that the generated cash (i.e., the 'free' cash-flow) comes without any attempt to increase sales or profit.

Case Study 2: Working Capital Management

Table 1 provides some indicators which reflect the performance of three companies of SENADA's clients in managing their working capital. The benchmark for the industry's average of the indicators is also included in the table, and the industry is furniture.

Table 1. Values of financial ratios related to working capital management

Company	Annual Sales (in billion Rupiah)	Working Capital Days (in days)	Days Inventory Outstanding (in days)	Days Sales Outstanding (in days)
Company 1	36.2	37.2	27	30
Company 2	140	160	104	51
Company 3	4.18	139	88	72
International benchmark for furniture industry	n.a.	79.4	50.5	46.9

Note: The international benchmark of the ratios were taken from CFO Magazine 2006

Looking at the working-capital indicators in column (3) to (5), Company A is suggested to have performed good working-capital management. The value of all of the indicators, namely Working Capital Days (WCD), Days Inventory Outstanding (DIO), and Days Sales Outstanding (DSO), are much less than the value of the indicators for the industry's benchmark (see the last row of the table). The low level of DIO and DSO for Company 1 indicates high degree of efficiency in the use of working capital. It implies that the money spent by Company 1 in production (e.g. for buying raw materials and paying wages) was quickly 'paid' by quite rapid sales of the goods produced. This is summarized in the short WCD value which indicates 'how long' the company's money is not held by the company.

Meanwhile, the high and above value of the indicators for Company 2 and 3 suggest high inefficiency in the business operation of the companies. In simple words, the company's cash money is just too long for being in circulation outside the company. As explained throughout the report, the inefficiency could be caused by several factors, such as the absence of good inventory control and slow pace for the collection of receivables.

Case Study 2 continued

It is worth commenting here that in terms of overall company performance, we can predict that Company 1 should be able to outperform Company 2 and 3. This is because Company 1 is less financially constrained than Company 2 and 3, and therefore, Company 1 need to borrow significantly less amount of money than that of needed by Company 2 and 3.

Table 2 illustrates how much Company 2 and 3 could gain by making some moderate effort to improve their working-capital management. As illustrated, a moderate effort to have 15 per cent reduction in all 'days' indicators (i.e. DIO, DSO, and WCD) generate a significant value of 'fresh-cash' – relative to the size of company's sales. The amount of generated 'fresh cash' represents the reduction in the extent of companies' financial constraint, since the companies now can use the cash to finance their production without relying on loan.

Table 2. Improvement in the performance of working capital management: a scenario of a 15 per cent improvement

Company	Reduction in Working Capital Days (in days)	Reduction in Days Inventory Outstanding (in days)	Reduction in Days Sales Outstanding (in days)	Amount of cash Generated (in million Rupiah)
Company 2	24	16	6	9,300
Company 3	21	13	11	243

It is important to emphasize that any attempt – no matter how simple it is – could lead to big improvement in working capital performance. An experience of another SENADA's client illustrates this. A change in incentive system, from monthly-and-fixed to output-based salary, proved to be able to increase the rate of collection of the company's receivables. Shortly after the new incentive system was implemented, the company saw improvements in its financial performance, in particular, the reduction of WCD from 45 to 29 days.

3.1.3. ACCESS TO FINANCE

External finance determines the path of the firms' growth. Like in many developing countries, small and medium firms in Indonesia often face problems in acquiring 'cheap' external finance, and this also applies to SENADA clients. The source of problems comes from both firms and the financial institutions. Unless otherwise stated, here we refer to banks as the financial institutions, because they are commonly the main source for the external finance.

Inability of small and medium firms to meet requirements by banks underlies the problems from company side. The firms often fail to get loan because they do not have formal financial reports and/or collaterals. Even if they have some of these, in most cases the financial reports are not audited and there are some legal issues with the assets. Legal documentation, such as tax account number, can also be the source of the problem, although this mostly applies to smaller firms.

Another problem is that many small and medium firms, who in most cases do not have large profit margin, consider acquiring funding from banks a costly activity. Buresh et al. (2007) listed the component of the cost, such as commission, administration, and appraisal fee, which in total could cost firms about 1.5 per cent of the total amount of loan proposed.

As from the bank side, some factors underlie the problems. First, there is a rigid lending regulation set out by the central bank (i.e., Bank of Indonesia, BI). As a lesson learnt from the 1997/98 economic crisis, BI increased prudential standards for commercial bank lending. At the practical level, this is translated to stricter requirements for loan application, and more importantly, the requirements are not negotiable. Given the characteristic of many small and medium firms in terms of legal documentation, financial reporting, and collaterals, it is reasonable to see many of these firms are not able to acquire loans from banks.

It is worth noting here that Bank Indonesia actually has special program aiming at assisting small and medium firms. However, there is no clear idea on the approach of this program or the implementation of this program. This is reflected by very minimal central bank's credit instruments to facilitate the support for the small and medium firms.

The second factor is an existence of what so-called a sector negative list, which details the sectors in the Indonesian economy that do not have a strong or positive industry outlook. At the time when EI program was implemented, garment and footwear are sectors included in the list, and therefore it is difficult for firms in these industries to acquire loans from banks. Being less competitive to the products produced by Indonesia's competitors, in particular China, has been the main reason for the inclusion.

An issue with the negative list that raises some concerns is that banks tend to apply the same approach to all sub-sectors within the sectors included in the list. This clearly injures, for example, leather-footwear industry, which is classified under the declining footwear sector. According to SENADA's expert, Indonesian leather-footwear industry actually has comparative advantage and good prospect in international market.

The third factor is a presumption that small and medium firms do not have capacity and capability to run a good business. Therefore, the firms are not likely to be financed because of the high defaulted risk. This presumption originates from the perception that small and medium firms are often not run professionally with high-skilled managers. Banks therefore view that there is no guarantee for these firms to be able to sustain their good performance in order to meet the obligations of loan payment.

The problems above, however, do not affect all small and medium firms equally. Some firms do not appear to experience problems in getting loans from banks. Based on casual observation of several cases, the reason for this seems to be a long-relationship between the firms and the banks, and the strong credibility the firms have built over the course of their relationship with the banks.

What happened to firms with all problems outline above? Firms seems to have often resorted to a more-expensive financial sources, such as personal loan – which does not need collateral –, discounted receivables (i.e. selling the Post Dated Cheques (PDCs in advance at discounted value), and informal (i.e., private lenders). The implication is obvious, that is, the firms earn profit margin less than those which are able to acquire loans from banks. It is interesting to note that these firms do realize the higher financing cost and that they still prefer to have financing from these more expensive sources. This implies that the firms consider the cost of having a more expensive source of money – in terms of credit interest rate – is still lot cheaper than the transaction costs they need to pay for getting loans from banks.

It is worth here to slightly expand the discussion on PDC. The first point to make is that PDC serves as the most important external financing sources for many small and medium companies. The PDC becomes so important because of the rather unique production financing method: the companies need to make a cash-payment for their raw materials but they have to wait for the payment from the buyer for some period of time, which usually takes about two months or more. Therefore, there is a gap in production financing, and the most immediate feasible source of fund is selling PDCs at some discount rate.

According to another SENADA research (Buresh et. Al. 2007), the discount rate is about 2.5-3 per cent per month, and for a two-months PDC, this means that the PDC is valued at about 94 per cent of the full amount. The great importance of PDC for small and medium firms is reflected in the fact that PDC is accounted for about 50 to 75 per cent of the cost for producing a buying order, according to SENADA expert.

It is important to mention that, to some extent, the significance of PDC for small and medium firms is due to a weak bargaining power of the firms in dealing with their raw-materials suppliers. PDC financing is not usually applied by large firms because they have some power over their raw-materials suppliers – this is, of course, in addition to the larger stock of working capital in large firms, as well as larger chance for these firms in getting external financing from formal financial institutions (e.g. loans from banks, etc.).

3.2. EXPORT PROMOTION

Limited access to international market has been the main issue faced by SENADA clients. Three particular problems feature the issue, discussed in the next few paragraph. It is important to note that each of these problems is not mutually exclusive. Few examples highlighting these problems suggest that they are interrelated (see *Case Study 3*).

The first problem is a weak design specification. Large numbers of firms, that is, about 70 per cent of the total firms, only perform what so-called 'cutting-making-and-trimming (CMT)' activities. They do not carry out design development activities and are only given the designs by the buyers. There are only very limited numbers of firms within the clients that perform their own design development and that can come up with their own design.

It is important to note, however, that this problem is so significant in garments and footwear sector but not so in auto parts sector – this is within the SENADA IVC sectors. The implication of this problem is clear. That is, firms which produce their own product-design are able to market their products more easily compared to their counterparts which are so dependent with product-design from buyers. Obviously, the volume and value of sales should have been higher for the former.

Looking more closely, the inability of firms in creating product-design is likely caused by a very limited access to information or knowledge on the current trends and preferences prevailing in international market. This happens in most of the clients. This is in contrast to the general perception that the inability is caused simply because they are unable to perform product creation/development.

The second problem is the lack of knowledge to conduct export-related activities. The root of the problem is the fact that firms are not really well-informed or do not understand about mechanisms, procedures, or firm-level strategy that ensure a smooth exporting activity. Few examples highlight this problem. One being that firms are often unable to calculate the final-price of the goods, because they are unable to differentiate the unit Freight-On-Board (FOB) price from the unit of production price. As a result, firms do not realize that they actually under-price their products and hence, while competitive in terms of price, they often suffer financial losses or are only able to squeeze very minimal profit. Another example is the lack of knowledge about letter of credit (LC). The most common issue has been the absence of awareness for the binding-nature of terms and conditions set out in LC. Most of the time, the lack of knowledge leads to some discrepancy between the outcome set out in LC and practice. Some examples include the discrepancy in *Expiry and Place* (clause 31D), *Beneficiary* (clause 59), *Partial Shipment* (clause 43P), *Transhipment* (clause 43T), *Latest Shipment Date* (clause 44C), and *Document Required* (clause 46A). All these discrepancies obviously increase the 'transaction cost' for doing export, coming from some additional – but unnecessary –financial charges or penalties as result of the discrepancy.

The third problem is the lack of the firms' capability to successfully participate in trade fairs. Firms often conduct only 'last-minute' preparation for trade fairs participation. As a result, sample products are usually not well-prepared; both in terms of product quality and design, and firms usually do not have pre-contact with some potential buyers in the location of the trade fairs. All these say that firms are unable to maximize the benefit from participating in trade fairs. Moreover, the last-minute preparation renders firms a costly trade fair participation. There is a lot of cost components can be saved, (e.g. cost for shipping and accommodation) if firms allow a reasonable preparation time. According to SENADA's expert, it can take about six months before a trade fair.

A related point, many firms does not seem to realize the benefit of a well-prepared trade fair participation. Among other, the well-prepared participation increases the chance of firms in acquiring orders from many buyers. This is in contrast to only a few buyers if firms do not participate in trade fairs. More importantly, a well-prepared participation usually results in repeated export orders. This is certainly a great benefit, since the firms then should be able to sustain their performance through exporting.

SENADA designed its assistance to address the problems above. The assistance, part of which takes in the form of trainings, are focused on capturing the trend of design and different consumer preferences and providing information aimed at improving the firms' knowledge in conducting exporting activities. The former includes, for example, compiling models of product, conducting internet search, etc, while the latter includes the subjects such as, improving the knowledge of managers on LC, FOB price calculation, and export documentation (e.g. sales contract and shipping documents). The assistance was also aimed at building a formal management system to support export sales. An example includes the development of exporting system and documentation (e.g. a database of international buyers, statistics related to production, etc.).

Case Study 3: Several aspects of the problems related to export promotion

Preparation for trade fair. The following three problems often occur in the preparation of firms for a participation in trade fair. First, there is no attempt to prepare serious promotional materials. Sample products are often not well-prepared. Some examples are: 1) no attention to craft product design accordingly to the current trend and consumer preference associated with the export market in which trade fair is held, 2) no careful calculation of the quantity of product samples need to be shipped, resulting in a very high shipping cost, and 3) under-prepared other promotional supporting tools, such as brochure and warranty policy.

Second, there is no well-prepared determination of export price. As noted, firms often do not know how they compute an FOB price. In addition, most firms do not realize the great variation in export price across different location of export markets/destinations represented by the location of the trade fairs.

Case Study 3 continued

Third, there is no attempt to initiate or establish business communication long-before trade fairs is undertaken. Experience suggests this particular problem significantly reduce the chance of firms in getting deal with prospectus potential buyers. Often, firms made some attempts of business communication only at the trade fair, which is obviously not so effective, considering not only very limited time during the trade fair, but also the fact that many of the firms' competitors have established their communication long before the trade fairs.

An experience of one of SENADA's client who successfully closed export deals in its first trade fair participation suggests that tackling the problems above significantly increase the benefit from participating in trade fair.[1]

In addition to mastering the knowledge related to exporting activities, this client – with SENADA's assistance – focused on optimizing the unique characteristic of its products, which is a relatively high-end of leather goods. Considering a rather unique markets for its products, the company developed its products to be marketable in global market; and for this, the company focused in developing and improving the design of its products. The company made a strong effort for this by hiring some professional product designers.

A focus was also given to improve the effectiveness of marketing team of the company. Professionals specialize in marketing were hired and trainings were conducted to improve the ability of the company's marketing team to penetrate export market. An enormous effort was undertaken to search for prospectus international buyers, by actively making use almost all available sources, such as embassies, chambers of commerce, internet-web, business asso

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The experience of this particular client highlights how valuable it is to always try to stick in export market once it is able to sell in it. As it has been established in many other studies (Campa 2004; Bernard and Jensen 2004), starting to export is a very costly activities which makes a successful attempt in doing so a great asset for a company.

The role of export agents. A related subject, but not necessarily a problem for firms, is the role of 'export agents'. The key point is that, the agents may be needed during the early years but not necessarily when the firms have gained some experience in exporting. This is because, one hand, firms who do not have exporting experience may likely need some assistance to penetrate export markets, which can be provided by the agents. In particular, the agents can help the firms to have some connections with potential buyers in the markets and to deal with delivery commitment, which is usually rather nonnegotiable. The role of agents is important for the reason of fiercer price competition in the current global environment. Fiercer price competition originates from the rise of Indonesian new export competitors, including from China and Vietnam, which are able to offer more competitive price.

Case Study 3 continued

On the other hand, export agents increase the risk of losing buyers, for the reason that the agents could switch export orders to other exporters. Export agents also reduces profit margin, owing to transaction fee claimed by the agents.

It is interesting to note that the company's effort in hiring the professional (i.e. the product designers and those in marketing team) was enormous. This is in terms of rewards given to the professionals, by designing and implementing an attractive salary/compensation package. Given the limited resource owned by the company, because it is a medium size of the company, the attractive package was designed to be positively related to the output; that is, the monetary compensation is larger or better if the professionals perform well. Thus, in other words, the company applied a modern approach in human resource management. This was actually so rare for small and medium firms in a developing country like Indonesia.

Managerial skill and export participation. Other common problems often faced by Indonesian exporters are the difficulty to find international buyers and lack of managerial skill to develop export sales. These problems can be nicely illustrated by the experience of another SENADA client who was struggling in the attempts to revive its export sales after a dormant period of exporting activity. The company had been unsuccessful in getting potential international buyers that they lost due to the failure of the company's management in sustaining its export sales.

The root of the problems appears to be the lack of managerial skill to support export sales. The following three examples highlight this. First, the client does not have and prepare a formal documentation about their production which can be used to predict the exact capacity for serving export market and the reasonable export price. As for the latter, it was revealed that the client include the domestic promotional cost, which is quite big for this company, in the price determination of exported goods. This practice obviously does not make the client to be more competitive than its competitors.

It was also revealed that the company does not maintain a database for its past-, current- or potential-international buyers. The database is obviously needed to increase the chance of acquiring export orders, since an international buyer does not always buy from one company.

Second, the managers of this company also failed to make them updated with new developments related to export procedure or any other modern export-marketing approach. The managers, for example, are unable to fill-in the new system of on-line export documentation set up by Indonesian Custom Agency. The managers, also, often fail to quickly or seriously follow up any product inquiry from potential international buyers. As was revealed during the SENADA assistance, the company actually received quite significant amount of the product inquiries.

Related to this, the company seldom participated in trade fair. This was in contrast to the period in which the company exported quite significantly of its products, where at that time, the company regularly and frequently participate big trade fairs in the major' company export-market targets, such as in Japan, Korea, US, and few countries in European continent.

3.3. OPERATIONS AND LOGISTICS

Weak attention to the importance of inventory and production management characterises the operation of most SENADA clients. Problems at the ground level include, for example, no proper documentation on the flow of raw materials and finished products, unorganised warehousing system, and no system for handling production plan.

Therefore, there is often a 'not-smooth' production process where machines are often shut down, due to the lack of supply of raw materials. This causes late delivery which can be badly affect firms, because firms need to pay penalty for the lateness. This situation occurs quite frequently and sometimes builds a weak credibility of the firms. Therefore, in some cases the problem results in an unsustainable job orders for firms. It is worth mentioning here a related problem where firms often fail to correctly calculate the optimal level of raw materials or components they should outsource to other smaller producers. As a result, these firms often end up with over-stock of raw materials or components supplied by other firms.

The problems in logistic and production management do not only reduce sales, but also lower firms' efficiency performance. Firms likely operate with very low level of labour productivity. This is consistent with casual observation that firms in Indonesian manufacturing tend to be less competitive in terms of labour productivity with firms in other developing countries.

It is also important to mention that some firms – particularly those in footwear and garment industry – are unable to improve their financial efficiency due to their strong dependency on the suppliers of raw materials. In many cases, firms in these industries are required by the buyers to buy raw materials from some specific suppliers. Therefore, the firms are unable to seek suppliers which can give the lowest price for the raw materials. It is important to elaborate the impact of the absence of system in production management. The key issue here is the absence of control mechanism. Not only 'not-smooth' production process and late delivery, the absence of control increases the extent of the goods' defective rate. Higher defective rate corresponds to higher unused raw materials – which then becomes 'production waste' – and, for this reason, it leads to higher production inefficiency.

Experience with the clients suggests that what really missing is the formal approach for monitoring production – the approach often taken is 'ad-hoc' one. The absence of formal approach does not allow firms to establish a consistent learning-by-doing mechanism, resulting in a never-improved quality of goods. For example, there is no guarantee that a thorough assessment on the defected product is conducted, albeit a step to check the quality of the final product is included in the 'ad-hoc' approach. Consequently, workers have never learnt from the defected product and the defective rate therefore tends to be persistently high over the time.

The lack of awareness can be contributed to at least two factors: (1) lack of knowledge, and (2) the costly characteristic for building a good production and inventory system. The former relates to the fact that many small firms are weak in their managerial capability. Limited access to resource constraints firms to hire capable managers. The latter relates not only to constraint in hiring capable managers, but also to opportunity cost involved if firms attempt to reform their management system.

Overall, the lack of good inventory and production system pictures the idea of 'limit to growth'. At some points, it restraints a firm's potential for growing despite, for example, high market demand. Casual observation from the interviews suggests that firms' expansion in responding to higher market demand does not seem to be followed by a development of good inventory and production system. It obviously weaken the extent of the firms' competitiveness, because it does not allow the firms to benefit from economies of scale (i.e., in terms of lower per-unit production cost).

3.4. MARKETING

The key issue with marketing is the very minimal effort undertaken by firms in penetrating market. This is represented by the fact that most firms do not have a clear and sound marketing strategy. In particular, these firms do not apply the formal approach of marketing mix, or often know as '4P in corporate marketing literature ('Product, Place, Promotion, and Pricing'). Some examples include a strong persistency of not changing product model or design and lack of skill of the sales people.

The absence of market penetration activity could be the result of strong dependency between firms and agents/firms that buy the product (buyers). This strongly occurs in footwear, garment, and auto-part industry. As for the auto-part companies, which serve the major automotive assembly plants in Indonesia, the buyers provide all production aspects, including design product and technology specification. This relationship to some extent does not allow the auto-part firms to expand their market to retail consumers.

The extent of dependency problem is worsened by very small numbers of buyers. In some cases, firms only sell to only one buyer. The situation in furniture cluster in Jepara highlights this, where about 90% of the products are sold only to one buyer. The strong reliance puts quite large risk for firms for losing production orders and gaining only very small profit margin. It allows buyers put credible threat of switching to other producers which results in very low bargaining power by the companies – this is suggested by the experience of furniture producers in Jepara. It is worth mentioning here that the strong reliance occur in Jepara's furniture industry to be determined by strong loyalty to the buyers, owing to the fact that most firms were originally established by the buyers.

Theoretically, this problem can be solved by widen the market in order to serve more buyers. However, doing so is also problematic. Lack of marketing-managerial skills is the likely the contributing factor. In practice, this is translated in the incapability or lack of awareness by the managers to undertake marketing intelligence activities. The lack of knowledge on exporting activities (e.g. procedure in dealing with LC, export price determination), as well as the high cost associated with marketing intelligence activities, turn out to exacerbate the problem.

It is worth mentioning here that strong dependency between many SMEs and agents/buyers might not be a 'wrong' strategy to follow. But this only applies under the condition that firms put some limit on the extent of the dependency. In the cases where dependency is beneficial, there is usually a limit in terms of how long the SMEs should be dependent on the agents/buyers. What happens in Indonesia does not fit into this ideal situation, however; many of the SMEs are just unable to cut the dependency and this could well translate into the problem described above.

Case Study 4: Marketing challenges

The following are two marketing problems faced by a SENADA's client, which was a small-company in footwear industry. They reflect the common problems often faced by small and medium firms.

First, there is no or weak marketing team. In most cases, marketing tasks are attached as additional tasks to the other tasks, which mostly are operation or production related-tasks. In some firms this problem is caused by the lack of human resource. An immediate impact is no strong focus in the attempt to increase sales performance or to expand market.

Case Study 4: Marketing challenges

Second, there is no a well-planned and well-structure marketing strategy, particularly in implementing the 4Ps approach. As noted, this does not help in ensuring a success marketing campaign or efforts because there are no indicators for monitoring and keeping the marketing activities on checks. Uniquely occurred in this company is the issue of a weak product presentation in the company's retail outlets, including the unskilled sales promoting people.

Another experience by another SENADA's client stresses the lack of marketing focus. It was only after a close assistance by SENADA's expert that this client realized its idle production capacity that can be used to serve other markets. The market expansion that follows successfully improved the company's sales performance. In particular, an expansion to other geographical location increased the company sales by almost 40 per cent.

3.5. FEW ORGANIZATIONAL ISSUES

Interview with SENADA experts suggest that some firm-level constraints are related to some organisational issue. The most important – but general – impact is that the clients are sometimes reluctance to change, not only in respond to SENADA assistance or advice, but also from any change in business environment that requires some adjustment by firms. The style of family-run business seems to be the underlying factor creating the problem. A strong top-down approach from owners to managers occurs in many of the SENADA's clients. This is reflected, for example, on the frequent occurrence of conflict of interest between the owners and managers on some ideas for improving firms' competitiveness and performance. The strong top-down approach seems to be effective when owners are visionary, however. It was suggested that firms with visionary owners tend to perform better than their counterparts with non-visionary owners. Visionary owners, for example, have the idea that their products can reach international market or that their firms are able to growth at reasonable high rate. It was also noted by the experts that implementing assistance is much easier and tends to create more positive results when owners of the firms are visionary.

Education level could be an important factor for determining how the style of family-run business adversely affects performance. This is based on casual observations. Firms with highly educated owners tend to be visionary, less reluctance to change (i.e. implementing reforms suggested by the experts), and focus more on external issues (e.g. how firms expand to export market) – rather than internal issues (e.g. How firms improve labour productivity). Further research on the role of education is obviously needed. This is because the experience with some other SENADA clients suggest that owners' education level does not necessary the determining factor. The other experiences indicate that entrepreneurship could be the more important factor than education level.

Another important organisational issue is the lack of managerial skill of managers/operators in many SMEs. The lack of managerial skill contributes to the inefficient and ineffective managerial decision often found in many SMEs. Two factors seem to create the problem. First, SMEs are simply unable to offer the capable managers in the market with a 'right' incentive. Often, SMEs are not able to pay the market-rate salary of these managers and as a result, they often end up employing with less capable managers. The second factor is related to the characteristics of family-run business. It is often the case that some managers still have some family-relationship with the owners.

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