



## **Development of Good Sme Governance in Indonesia : An Empirical Study of Surabaya**

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### **ABSTRACT**

Small and Medium-sized Enterprises (SMEs) play an important role in economic development in Indonesia. They are, however, facing a dynamic and complex market situation and stiff competition in the era of the ASEAN Economic Community (AEC). Therefore, in order to survive and grow in this challenging situation, SMEs need effective application of good governance in the running of their business. Moreover, the implementation of good governance will be able to improve performance and maintain the viability of SMEs in the face of free trade. In response to this phenomenon, this study aims to examine the effect of the principles of good governance (transparency, accountability, responsibility, independence and fairness) on the performance of SMEs in Surabaya, which is measured by growth in sales turnover, in profit, and in the number of customers. The samples used were the owners and managers of SMEs in Surabaya and analysis was conducted by a validity and reliability test, and a statistical test with PLS (Partial Least Squares). The results show that the principles of good governance, consisting of transparency, accountability, responsibility, independence and fairness, have a significant effect on the performance of SMEs in Surabaya.

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## INTRODUCTION

SMEs play an important role in the Indonesian economy in terms of business, market creation, innovation and job creation. According to data from the Financial Service Authority (OJK, 2016), with a contribution of 58.9% of Gross Domestic Product (GDP) and of 97.3% of employment, the presence of SMEs is key to national economic growth. In addition, they are the business group that can survive well in a variety of conditions, which is evidenced by the increasing number of SME units in Indonesia. Similarly, Risma Harini, the Mayor of Surabaya, stated that the number of SMEs in Surabaya had grown rapidly, from 92 in 2010 to 3000 in 2016 (Chandra, 2016). This significant growth in Surabaya is the result of Risma's program of spreading entrepreneurial spirit to all of Surabaya society and encouraging people to start businesses. In addition, the program is in line with the project of the Indonesian government to provide a financial aid program for SMEs in the form of low rate financing as initial capital. However, to develop SMEs, there still exist a number of problems, ranging from the lack of access to capital and to markets, to the limited skills of the human resources (HR). Especially in the area of free trade, SMEs must be able to compete with the foreign products that have flooded Indonesia. Therefore, creative and innovative ideas and good governance are required, which will be able to improve the performance and competitiveness of SMEs, so that they can be market leaders in the domestic market, and they should even be encouraged to compete in the global market.

The SME is also a type of business which has competitive ability when faced with competition (Byrd and Megginson, 2009). Şener, Savrul & Aydın (2014) state that it is a dynamic, flexible, innovative, productive and competitive business. Moreover, with the implementation of the ASEAN Economic Community in 2015, SMEs face very big opportunities, but at the same time challenges. This means that all ASEAN countries, including Indonesia in general and Surabaya in particular, will be free markets for goods, services and labor, without any barriers between countries (Rapih, Martono and Riyanto, 2015).

The major role of SMEs indicates that this sector is very important and thus requires attention in terms of governance, especially in the face of the free market. SMEs are required to continually improve in order to be able to compete with others. Therefore, to survive and thrive, they need to implement good governance in their operations. Governance is a system or an approach that regulates and controls the relationship between management and the parties involved with the company, aiming to create added value for all parties concerned with the company, in this case the SME.

Governance is not a new term in business. It is the relationship between companies' management and directors, and the shareholders and stakeholders involved with them (Abor and Adjasi, 2007). Memili (2011) and Culasso et al. (2012) state that the quality and sustainability of a company can be determined by the application of good governance. In reality, however, some people still believe that governance is only suitable for large companies, and that SMEs do not need it (Jorissen et al., 2005).

Such an opinion is certainly not appropriate, because SMEs are in urgent need of good governance for their sustainability; on average they only last for about 10 years. This is because not all SMEs show a good performance. There are many obstacles to the survival and development of their business, including limited information, limited access to resources, and the lack of good corporate governance (Maury, 2006). Thus, the application of governance is vital and is an important requirement for the survival of a business and the economy (Purwanto and Mustamu, 2013). According to Wahyudi (2008) and Binhadi et al. (2006), there are values in governance that can be used as a reference by both large and small companies. These values are transparency, accountability, responsibility, independence and fairness.

Hidayat and Herlambang (2009) state that the development of SMEs through the provision of credit and formal entrepreneurial education does not directly improve their performance, but that these must be followed by the implementation of good governance. In order to continue to grow, develop and improve their performance, it is necessary for SMEs to implement the principles of good governance. Performance is an indication of the work of an enterprise. It is often used as a measure of success, for SMEs this being through the achievement of growth in sales turnover, in profits and in the number of customers (Chrisman and McMullan, 2002).

Based on the above description, the research question in this study is “Could the application of good governance improve the performance of SMEs in Surabaya?” Consequently, the purpose of the research is to understand the extent of the implementation of good governance of SMEs in Surabaya, and its effect on their performance. The results are expected to be useful and provide a basis for the consideration and guidance of SMEs to improve their performance by adhering to the principles of good governance.

## **LITERATURE REVIEW**

Binhadi et al. (2006) state that there are five main principles of governance, namely transparency, accountability, responsibility, independence and fairness. SMEs need to survive and succeed, so a proper governance model is needed to help the sustainability of their businesses (Memili, 2011).

Tangkilisan (2007) states that the implementation of good corporate governance can clearly help increase corporate performance, by up to 30 percent above normal profit levels. Meanwhile, Tunggal and Tunggal (2002) assert that the implementation of good corporate governance provides the following benefits: improvements in communication; minimization of potential conflict; improvement in productivity and efficiency; continuity of benefits; promotion of corporate image; increased customer satisfaction; and acquisition of investor confidence.

Anderson and Reeb (2003) argue that family businesses will be successful if managed by the family itself, compared to management by talent outside the family, because they are only engaged professionally, but do not emotionally belong to the business objectives of the family. They also state that combining ownership and control allows the business to be monitored so that family ownership is effective.

Palupijati (2013) states that governance principles have already been implemented in both family and non-family SMEs, but shows that neither type of business has maximized this implementation. This situation occurs because there are some differences in the implementation of governance between family and non-family businesses. The differences are related to ownership and business structure; the more concentrated the ownership and business structure, the lower the implementation of governance, meaning that the company is less transparent, less accountable, less responsible, less independent and less fair. However, companies whose ownership and business structure are less concentrated then the application of the five governance principles is better.

Company competence is highly dependent on how the company manages, mobilizes and develops its resources (Banerjee, 2005). It is the result of the accumulation of how corporate governance is able to develop, organize and mobilize resources through information, skills, capital, and improvement in management knowledge and technology utilization. Therefore, in order for the company's competence to be achieved, it needs to arrange its owned resources through governance, so that this competence, which is a reflection of company performance, can be achieved. The research conducted by Hidayat and Herlambang (2009), who examined the influence of government guidance on the performance of the SME industry, showed that coaching conducted by the government of Madura on how to access financing from banks did not necessarily improve performance, but in fact degraded it. In addition, the formal and centralized education related to entrepreneurship was also not able to improve the performance of SMEs in Madura. The study found that the formulation of some operational policies, such as openness of management, fair treatment and freedom of expression, were important in running the company. Therefore, these policies should also be considered by the government in running and controlling business in order to achieve its performance.

Almilia et al. (2013) state that those running SMEs still lack management awareness of the importance of business planning, job descriptions and training for employees. This frequently happens in SMEs in which management is still centered on the company owners. In addition, the lack of awareness of SME management is related to the use of the latest technology in operational activities and low innovation in the quality of management systems. If such a situation is allowed to continue, it means that SME management will ignore what is lacking, so company survival will be at risk. Therefore, renovation is required, meaning that the company should clean up and organize its affairs; in doing so, SMEs should be transparent, accountable and fair. Moreover, governance is essential for healthy and competitive company development.

In addition, by implementing good governance, a stronger and better internal control system, which is accountable, transparent, independent, responsible and fair, will be created (Ramakrishnan, 2013).

Ijeoma and Ezejiofor (2013) state that corporate governance has made a significant contribution to improving the transparency and accountability of small and medium-sized enterprises, and in turn to improving corporate performance; governance also makes it easy to show social responsibility for the environment. In addition, good governance can help to develop effective and efficient corporate strategic planning.

Magaisa et al. (2013) recommend that implementing good governance in SMEs in Zimbabwe is very important, because it is suspected that the failure of these companies is caused by the way the businesses are run. In practice, an SME manager is expected to bring new ideas, and facilitate and implement strategies for enterprise development. Therefore, with the implementation of governance, the various parties, namely employees, managers and the owners of capital, can contribute to the promotion and improvement of the performance of the company.

Dzama (2015) states that Zimbabwe faces economic challenges in the form of many closure companies, resulting in unemployment. The situation made the government encourage its citizens to start to establish businesses in the form of SMEs. It has encouraged people to start establishing projects or SMEs that can provide their own income. In response, the government provides financial assistance to people who want to start their own business, so that the SME can be successful. In addition, the government has also asked the SMEs to follow the practice of governance to help them achieve their goals. The governance characteristics that must be applied by SMEs include the establishment of a clear strategy, effective risk management, discipline, fairness, transparency, social responsibility and self-evaluation. By applying these governance characteristics, the government hopes that the SMEs will be able to survive and develop.

Hanifah (2015) states that the implementation of good governance in SME business is an effort to increase operating income, as most of the income of SME businesses is still at an average level. Therefore, there is still much to be overcome, especially accountability and transparency; they are still very weak, which means that responsibility, independence and fairness are still not good. However, SMEs need to apply governance together so as to achieve business performance in accordance with their intended purposes.

Based on the results of the studies described above, the hypothesis in this study is that the implementation of governance, which consists of transparency, accountability, responsiveness, independence and equity, has a significant positive effect on the performance of SMEs, associated with growth in sales turnover, profits and customers.

## RESEARCH METHODOLOGY

This research is based on a survey approach (Kuncoro, 2013), using questionnaires as a tool for obtaining data from respondents who run SMEs domiciled in Surabaya. The endogenous variable in the study is the performance of SMEs in terms of growth of sales turnover, profit and number of customers. The exogenous variable is governance, which consists of transparency, accountability, responsibility, independence and fairness.

The population of the study are owners of SMEs in the Surabaya area. The sampling technique used was non-random sampling, with judgment sampling (Cooper and Emory, 2005). The sample criteria of the respondents are that they are Surabaya residents who have run a business in Surabaya for at least two years, that they set up their own business (did not inherit it) and have legal status. 250 questionnaires were distributed, but only 150 were returned, of which 96 were completely filled in. The data were also collected through observation: direct observation in the field; direct interviews with the owners of SMEs; and a Focus Group Discussion (FGD) involving representatives of SME management, entrepreneurship practitioners and academics, during the period February – December 2016.

The analysis technique used was the Partial Least Squares Structural Equations Modeling (PLS-SEM) approach. There are two stages in the PLS-SEM modeling process (Hair et al., 2011). First, the measurement model is evaluated for reliability consistency and internal validity. Second, the structural model is assessed to predict the relationship between the endogenous and exogenous variables.

The most common business field of the respondents in the research is trade, at about 81%, while 19% are involved in the service field. The average length of business operation is less than 10 years, the type of business is family business, the business history is self-pioneering, and most businesses are illegal entities. The number of employees is only around 1 to 4 workers, with sales of less than Rp100.000.000 per annum, sales turnover growth of about 10%-30%, profit growth of about 10-30%, and customer growth ranging from 10% to 30%. Customers are based in Bali, Kalimantan, Malaysia, Hongkong, Singapore, Thailand, East Timor, China, Netherlands and Vietnam. From this description, it can be seen that SMEs need to work hard to improve their performance; that is, by establishing the companies through governance, because it is evident that if they pay attention to governance, then their performance will improve.

According to Harjito and Singapurwoko (2014), there is a significant relationship between agency supervision and the performance of family companies; this means that a necessary supervision mechanism in managing the company or SME which is a family business, and for companies that have been established for more than 5 years, can increase sales turnover. Similarly, Abor and Adjasi (2007) state that if a family company is not well managed, with a lack of attention to governance and limited access to resources, it will have an impact on performance.

Anderson and Reeb (2003) also reveal that family businesses will succeed if they are managed by the family itself, rather than by outsiders. Their approaches are totally different, because outsiders feel that the company does not belong to them, so they do not take hard work seriously.

Moreover, Chua et al. (2004) explain that successful businesses are usually initiated by the existence of family involvement. If family businesses are well-managed and concerned with governance principles, they can transform themselves into large companies. In addition, governance principles have a balancing and controlling function within the company, either internally or externally.

Palupijati (2013) states that different types of business lead to different implementations of governance, especially between family and non-family businesses. The differences exist in the ownership and business structure; with higher concentration of ownership and business structure, there will be less implementation of governance, meaning companies are less transparent, less accountable, less responsible, less independent and less fair. Otherwise, for companies whose ownership structure and business structures are less concentrated, then the application of the five principles of governance is better.

## RESULTS AND DISCUSSION

The reflective measurement model was assessed by evaluating its internal reliability and validity. Hair et al. (2011) assert that a reliability test should focus on composite reliability as an estimate of a construct's internal consistency. The tolerance value of composite reliability is 0.60 to 0.70 in exploratory research and 0.70 to 0.90 in more advanced stages of research. The validity test then evaluates the measurement model related to convergent validity. To establish convergent validity, the researchers considered the outer loadings of the indicators, as well as the average variance extracted (AVE) (Hair et al., 2011).

Variable	Indicator	Loading Factor	Composite Reliability	AVE	Note
Transparency	<b>T1</b>	<b>0,411</b>	0,826530	<b>0,411225</b>	reliable invalid
	<b>T2</b>	<b>0,663</b>			
	T3	0,675			
	T4	0,625			
	T5	0,729			
	T6	0,735			
	<b>T7</b>	<b>0,594</b>			

Table 1 Cont.

Variable	Indicator	Loading Factor	Composite Reliability	AVE	Note	
Accountability	A8	0,608	0,828987	<b>0,386720</b>	reliable	
	A9	0,769				
	A10	<b>0,385</b>				
	A11	<b>0,475</b>				
	A12	0,684				invalid
	A13	0,727				
	A14	0,675				
	A15	0,554				
Responsibility	R16	0,874	0,868222	0,688605	reliable valid	
	R17	0,877				
	R18	0,730				
Independence	<b>I19</b>	<b>0,358</b>	0,775891	<b>0,422188</b>	reliable invalid	
	I20	0,719				
	I21	0,786				
	I22	0,692				
	I23	0,608				
Fairness	<b>F24</b>	<b>0,620</b>	0,755128	<b>0,494375</b>	reliable invalid	
	F25	0,780				
	F26	0,735				
	F27	0,667				
Performances of SMEs	K1	0,800	0,881668	0,713321	reliable valid	
	K2	0,890				
	K3	0,841				

Table 1 can be explained as follows. Referring to the value of composite reliability, it can be stated that all the indicators of governance are reliable because it is shown that the composite reliability values are greater than 0.70. Meanwhile, the results of the validity test show that there are four variables whose indicators are invalid because their AVE scores are below 0.50, namely the indicators of transparency, accountability, independence and fairness.

Therefore, in order for these four variables to be valid ( $AVE > 0.50$ ), there needs to be modification. Modification of the transparency variable was made by omitting some indicators, such as T1 with loading factor 0.411, T2 with loading factor 0.594, and T7 with loading factor 0.663. The remaining indicators of the transparency variable used for further analysis were T3, T4, T5, and T6, with an AVE score of 0.556751.

Subsequently, modification of the accountability variable was made by omitting some indicators, such as A10 with loading factor 0.385, A11 with loading factor 0.475, and A15 with loading factor 0.554. The remaining indicators of transparency used for further analysis were A8, A9, A12, A13 and A14, with an AVE score of 0.524833.

Modification of the independence variable was then made by omitting one indicator, I19 with loading factor 0.358. Thus, the remaining indicators of independence used for further analysis were I20, I21, I22 and I23, with an AVE score of 0.515849.



The same treatment also was applied to the fairness variable, by omitting one indicator, namely F24 with loading factor 0.620. The remaining indicators of fairness used for further analysis were F25, F26 and F27, with an AVE score of 0.601916. All the indicators of governance variables are therefore reliable and valid; the results of the modification can be seen in Table 2 and Figure 1.

Table 2 Modification of Measurement Model Results

Variable	Indicator	Loading Factor	AVE	Composite Reliability
Transparency	T3	0,657	0,556751	0,832967
	T4	0,727		
	T5	0,838		
	T6	0,751		
Accountability	A8	0,657	0,524833	0,845881
	A9	0,821		
	A12	0,682		
	A13	0,743		
Responsibility	J16	0,874	0,689009	0,868477
	J17	0,877		
	J18	0,730		
Independence	I20	0,675	0,515849	0,809021
	I21	0,798		
	I22	0,736		
	I23	0,658		
Fairness	K25	0,780	0,601916	0,819365
	K26	0,775		
	K27	0,772		
Performance of SMEs	Y1	0,800	0,710295	0,880094
	Y2	0,890		
	Y3	0,841		

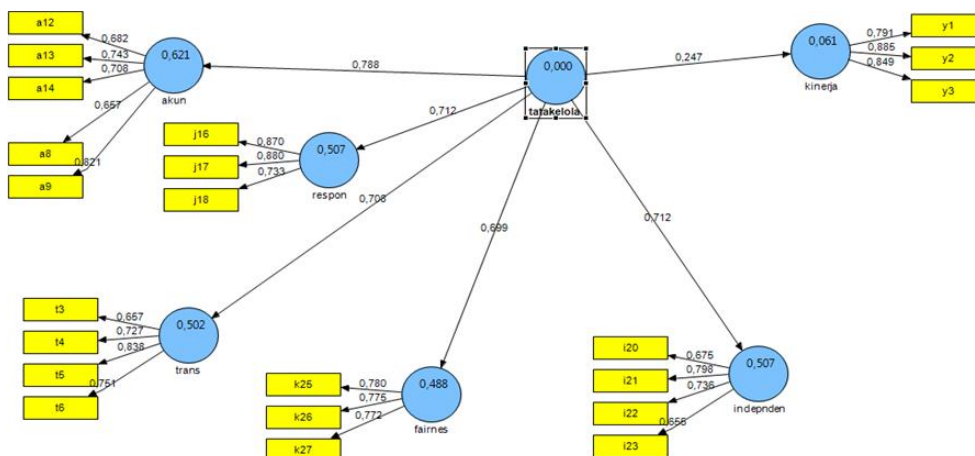


Figure 1 Structural Model Test Results

Referring to Figure 1, the AVE scores of the governance variables and performance of SMEs are above 0.50, and composite reliability is greater than 0.70. This means that all the indicators of the governance variables, which consist of transparency, accountability, responsibility, independence and fairness, and the performance of SMEs related to sales, profit and customer growth, are valid and reliable as a measurement model of governance of the performance of SMEs.

After ensuring the indicators of each governance and performance variable were valid and reliable, the research continued by examining the effects of transparency, accountability, responsibility, independence and fairness on SME performance, as follows:

Table 3 Variable Test of Governance of SME Performance Results

Variable	t statistics	t table	Result
Transparency	9.593	1.96	Significant
Accountability	12.588	1.96	Significant
Responsibility	10.181	1.96	Significant
Independence	8.660	1.96	Significant
Fairness	8.753	1.96	Significant
Performance of SMEs	2.741	1.96	Significant

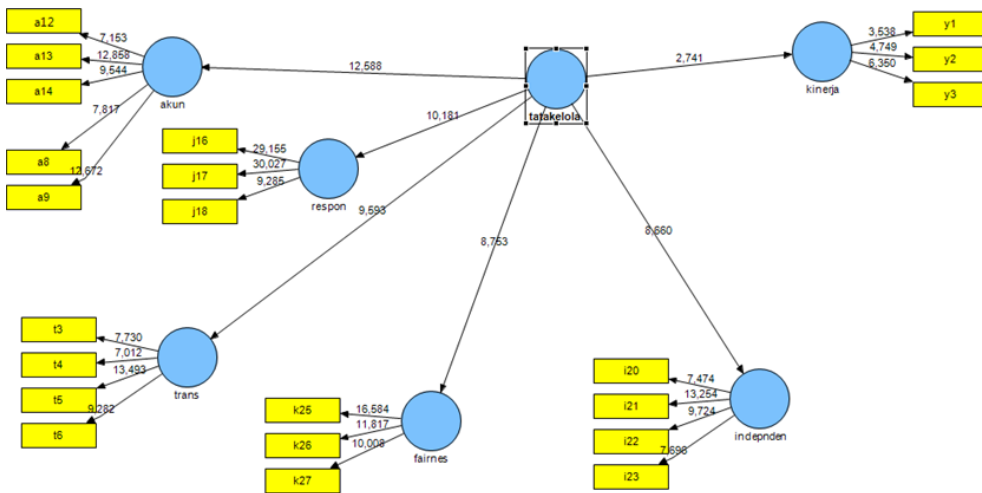


Figure 2 Test of Structural Model of Governance of SME Performance (Inner Model) Results

Table 3 and Figure 2 show that transparency, accountability, responsibility, independence and fairness have been statistically proven to be a form of governance because  $t_{statistics} > t_{table}$ . The most significant form of governance is accountability, with a  $t_{statistics}$  value of 12.588, followed by responsibility with  $t_{statistics}$  value of 10.181, transparency with a  $t_{statistics}$  value of 9.593, fairness with  $t_{statistics}$  value of 8.753, and independence with a  $t_{statistics}$  value of 8.753. In addition, both Table 2 and Figure 2 show that governance significantly influences the performance of SMEs, with a  $t_{statistics}$  value of 2,741  $>$   $t_{table}$  1.96. As a result, this study proposes that variable

governance, consisting of accountability, responsibility, transparency, fairness and independence, influences SME performance.

Based on analysis of the results, it is established that accountability has a dominant influence on performance. The dimension of accountability is also the most important measurement of governance according to the SME respondents in Surabaya, meaning that SMEs should have a good control system; have clarity of functions; clarity of implementation and accountability; should maintain employee safety, employee salaries; and pay attention to product quality. The results of this study support the previous research conducted by Sucipto and Harjanti (2014), who state that clarity of functions, system and responsibility are important, because they can enhance the performance of a company. However, the results of this research are not in line with Hanifah (2015), who argues that much still needs to be improved, especially the accountability factor. This means that SMEs in Surabaya should pay attention to growing regulation, especially nowadays in the face of free trade.

The next governance measurement is responsibility, meaning that SMEs should respect external rights according to any agreements; for example, those associated with products sold to target customers, which must be in line with what has been promoted. SMEs have mechanisms that can manage the responsibilities of all work units and they are responsible for the products being made; for example, halal products and expiry dates. This research supports that of Hanifah (2015), who found that SMEs generally have applied principles of responsibility and fairness. Moreover, it has been proven by those running SMEs in Surabaya that responsibility is key to success in business, especially when facing free trade, because SME products are of a quality that is not inferior to those that come from outside, for example from China, America and other countries. The results of this study also support the work of Munizu (2010), who explained that both internal and external factors positively influence the performance of SMEs. Internal factors refer to products which must meet quality standards and conform to expiry dates, while external factors refer to the responsibility of SMEs to follow all regulations in the running of their business.

The principle of fairness is already well-established in SMEs, which give fair treatment to their employees. In detail, compensation systems for employees are fairly implemented and follow the applicable regulations. Punishment systems are also applied to employees who commit acts of violation, but unfortunately no rewards are given to employees who have done excellent work. In addition, SMEs involve external parties in decision making and provide an opportunity for these to argue on behalf of all employees. Moreover, Mukharomah (2010) asserts that in order for SMEs to have a competitive advantage, and a healthy and strong performance within their industry, then they must apply the fairness principle in running their business.

The independence principle shows that SMEs make an effort to avoid conflicts by giving training to all employees in order to improve their productivity. In addition, SMEs should be able to innovate to expand their business. Therefore, they have the freedom to seek information related to the advancement of knowledge and technology.

This means that SMEs can improve their performance by collecting extensive information from all relevant sources. Chowdhury et al. (2013) also state that the success of SMEs depends on the demographic characteristics, which are education, experience and the environmental factor, namely access to information, technology and infrastructure. Additionally, Almilia et al. (2013) argue that SMEs need to provide training for employees in using new technologies to support their operational activities. In addition, SMEs should continue to innovate in order not to be left behind by other SMEs located outside Surabaya. The same opinion is also held by Chevers et al. (2014), who stated that to strengthen good governance in achieving performance SMEs should include information technology (IT) as an internal controller, meaning that with IT SMEs can then search for information needed more freely and ultimately compete successfully in the business world.

## CONCLUSION

Based on the results of the analysis and discussion, it can be concluded that accountability is the most dominant principle of governance that influences the performance of SMEs, followed by responsibility, transparency, independence and fairness. The overall implementation of these governance principles has a significant effect on the performance of SMEs in Surabaya.

For further research, we recommend that the respondents being studied are grouped together based on type of business, including family and non-family business, because this may lead to a different understanding in terms of governance. Additionally, the SMEs being studied could be grouped by business field or by similar business centers, such as shoe centers, batik centers, Muslim clothing centers, food production centers, bag centers etc. It would probably be an interesting discussion as to whether SMEs in the same center have the same understanding of governance. Lastly, it is recommended that the indicators of governance measurements use language that is easily understood by SMEs owners, so that it does not cause bias.

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