

## **Chapter 3**

### Small and medium enterprises, Distribution Channel, Innovation, AND Firm Performance

#### **3.1 Introduction**

This chapter explains the main themes of the study, namely, SMEs, distribution channels, innovation, and firm performance, derived from the available literature. The aim of this chapter is to present an overall concept of the themes. Hence, the definitions and relevant topics are highlighted in order to comprehend the role of the main variables to achieve the objectives of the study. The explanations of the addressed themes, afterwards, are used to guide the relevant empirical findings in order to identify the gap and to build the theoretical framework, which lead to the objectives of this study and this is incorporated in Chapter 4.

#### **3.2 Small and Medium Enterprises (SMEs)**

##### **3.2.1 The role of SMEs**

For many decades, studies conducted on SMEs have found them to be, by count, the most dominant establishments in the globe. Thailand had a total of 2,287,057 enterprises. Of these, 4,292 (0.4%) were categorized as LEs, while 2,274,525 (99.5%) were classified under the SMEs category (Nagai, 2007, pp.161-163). In Malaysia, SMEs represent 99.2% of the total business establishments (Hashim, 2000, in Shankar, 2010, pp.27-28). In Korea, despite the rise and fall in the total number of SMEs over time (1950s up to 1990s), they still averaged well over 80% of the total establishments (Yhee *et al.*, 2001, p.3) and in Indonesia, more than 95% of the total establishments were SMEs (Mukhamad *et al.*, 2011). This is also true for most of the countries in the world.

Owing to their establishment supremacy, they bring positive significant impacts in many economies. In Malaysia, SMEs contributed to 32% of the GDP, 19% of exports, and 56% of the employment force; and it has been expected to contribute even more by the year 2020 (Shankar, 2010). Based on the U.S. Census Bureau (2002), in excess of 100 million of the workforce worked in companies with fewer than 500 workers in 2001. Of these, 10.7% worked in industries with fewer than 10 workers, 18% in industries with fewer than 20 workers, 40,973,082 in industries with less than 100 employees, and 49% in businesses with fewer than 500 employees. In 2001, there were 2,697,839 American companies that employed fewer than 4 workers, contrasted with just 930 that employed more than 10,000 workers (Agyapong, 2010). While in 2009, Indonesian SMEs were able to generate as much as 2,993,151 billion IDR and shared 56.53% of the total added value (Mukhamad *et al.*, 2011). This also happened in other neighbouring countries, such as Singapore, Taiwan, Thailand, and South Korea. Contributions by SMEs towards employment ranged from 35% to nearly 61%, with the contribution to value added ranging between 22% and 40% (Salleh, 1991).

### **3.2.2 Definition of SMEs**

Literatures show that SMEs are different from LEs. Most of the differences are explained in respect to SMEs' assets, which are either tangible or intangible (Hudson *et al.*, 2001). Motivated by the capabilities of SMEs in generating jobs, poverty reduction, and value added (Salleh, 1991; Sankar, 2010; Agyapong, 2010; Tambunan, 2009), literatures have conceptualized SMEs so as to formulate a clearer definition and to define its characteristics.

Unlike LEs with large assets to produce large volumes of sales per year, SMEs, as seen in Table 3.1, has smaller capability for production. In Malaysia, enterprises that produce not more than RM10 million worth of goods per year are considered as small enterprises. If it achieves between RM10 million up to RM25 million, it is considered to be a medium enterprise (Shankar, 2010). In Indonesia, a firm that is capable of generating an annual sale of 300.000.000,00 up to 2.500.000.000,00 (IDR) is considered as a small enterprise. If the range is 2.500.000,00 up to 50.000.000,00 (IDR), it is deemed to be a medium enterprise.

On the other hand, a rather different case of SMEs concept could be found in Singapore. There, a firm that produces less than 100,000,000.00 Singapore Dollar worth of goods annually is considered an SME (ASEAN SMEs, 2011). Furthermore, another approach of the SMEs definition can be found in the context of assets. Among ASEAN countries, in Thailand, manufacturers or wholesalers who acquire assets of up to 50 million baths each and retailers that each acquire assets up to 30 million baths are considered small enterprises. On the other hand, manufacturers and service industries that acquire assets of 50 up to 200 million baths and wholesalers that acquire 50 up to 100 million baths of assets are considered to be medium enterprises (Thailand, 2002). In Cambodia, an enterprise that possesses assets from 50,000 up to 250,000 (USD) is considered a small enterprise, while a firm that achieves assets of 50 up to 200 million baths for a manufacturing and a service industry and of 250,000 up to 500,000 USD is considered a medium enterprise (ASEAN SMEs, 2011). According to “Indonesia-Menegkop and UKM Law No. 9 on Small Enterprises of 1995”, an enterprise that owns net assets of less than 200 million IDR (excluding land and building) is considered as an SME.

However, despite of the different views on SMEs, from Table 3.1, it shows that the number of employees has become a benchmark in defining SMEs and 1 up to around 250 employees working in the sector are considered SMEs. It is accepted that in Thailand, a firm that hires less than 50 employees is considered to be a small enterprise and a firm that hires 50 up to 200 employees is considered a medium enterprise (Thailand, 2002). However, in Brunei Darussalam, a firm which hires from 6 up to 10 employees is considered to be a small enterprise, while hiring 51 up to 100 employees classifies as a medium enterprise. On the other hand, similar concepts of SMEs are also found in Cambodia. There, a firm which hires from 11 up to 50 employees is considered to be a small enterprise, while a firm which hires 51 up to 100 employees is considered a medium enterprise (ASEAN SMEs, 2011). In Indonesia, according to “Menegkop and UKM Law No. 9 on Small Enterprises of 1995”, a firm that hires less than 100 employees is placed in the SME category.

### **3.2.3 The characteristics of small and medium enterprises (SMEs)**

Knowing that SMEs require less initial capital than LEs, SMEs have become easier to be established compared to LEs. Table 3.1 shows that the main contribution of SMEs for employment creations, poverty reduction, and value-added are generated by their establishments in sectors, which in, general consist of more than 90% of all business categories.

According to Green *et al.*, (2002), since education plays an essential part for firms to sustain and improve growth, as opposed to LEs that normally hire highly skilled staff and provide sustainable training to improve the productivity, SMEs only have a few highly

trained employees. This is usually due to the simpler production process than those in LE. Other impact of educational background of the SMEs manager or owner was found to be positive for capital access ability (Green *et al.*, 2002). Better educated owners or managers know how to look for necessary information and know how to present a proper case for a loan.

In addition, besides capital asset, other types of assets of SMEs are also found to be different from assets of large enterprises. It is usually found that large enterprises earn more tangible assets, like cash, deposits, securities, inventory, vehicles, machineries, buildings, land, and others compared to SMEs. They are mostly, however, long term assets (land and buildings). Without these long term assets, it has become a constraint for SMEs to get access to a loan on a long term basis. As a result, SMEs would rarely be able to increase their capital for their businesses as frequently as in LEs. This has hampered SMEs from doing more in terms of innovation. Nevertheless, according to Bougrain, and Haudeville, (2002), in spite of inadequate capital for improving or introducing new products and updating technology, Mezgar *et al.*, (2000) found that SMEs must innovate themselves to remain competitive and at the same time, they should manage their expenditures.

Besides, these SMEs are hindered by barriers for innovation, and hence, a study by Wittmann *et al.*, (2012) interviewed 82 top managers and owners from 41 SMEs in China established that SMEs command fewer resources, have less research and development, and encounter more uncertainties and barriers towards innovation compared to LEs. Franz, and Alexander (2001) found that the most frequent basis of product innovation by SMEs was redesigning their traditional products. Such innovation behaviour was also found in the

Norwegian SMEs. They also improve product quality and reduce labour costs. However, it is exceptional for the cases of SMEs in London and Wallonia, whereby studies have found the reluctance of SMEs to enter into or develop new markets.

On the other hand, some argued that SMEs do not need to change their structures and systems due to the limited range of products that they develop (Qian, & Li, 2003). SMEs in upper Austria generate innovations by specializing on niches (58.6% of SMEs) and improving their quality advantages (52.1% of SMEs). It can be concluded that due to the limited resources and marketing capacities, SMEs have difficulty in entering new markets as compared to large firms. The study by Zeng *et al.*, (2010) found that 188 manufacturing SMEs in China revealed that lack of technical expertise had become a significant constraint for SMEs to develop innovation, whilst cooperating with partners and endorsed by preferential tax policy had become helpful for SMEs in generating innovation.

Technology adoption of SMEs is also different from LE. Manufacturing SMEs are typically established around a single breakthrough technological capability and directing most of their resources towards commercializing their technology (Qian, & Li, 2003). Large manufacturing organizations, on the other hand, often received recognition for being innovative due to their abilities to redesign their work processes continuously by taking advantage of advanced technology and such continuous improvement methods as total quality management and just-in-time (O'Regan *et al.*, 2005). Furthermore, LE usually adopts and applies high technology which requires significant capital, while SMEs use available technology combined with traditional ones. The combination of human

involvement and technology in the business processes is applied frequently in SMEs. This approach has been adopted by SMEs for the sake of effectiveness and efficiency.

In LEs, the verbal and written interactions and coordination among staff are usually very formal, while in SMEs, it is the opposite. In this case, regional typical language and trust form a normal basis for relationship. This is in order to operate and maintain the relationship with their customers, for instance, for the purpose of transaction systems, promotions, and product delivery.

Many SMEs are operated in rural areas and the location understandably provides difficulties for them in acquiring effective transportation facilities. The ineffective system of transportation in the rural areas has also become a constraint to support the product flow towards end consumers. A study by Hendrawan (2012) found that accessible location of SMEs has impacted on the firm capability to grow. The study demonstrates that a reachable area of business provides advantages in building the financial network. Such locations, hence, enable SMEs to provide a better and effective operation and have higher probability of obtaining financial aid compared to those established in sub-urban areas.

Table 3.1 Small and medium enterprises (SMEs)

<b>Categories</b>	<b>Small</b>	<b>Medium</b>	<b>References</b>
<i>Number of employees :</i>	Less than 50 workers in manufacturing industry	Ranged between 51 up to 200 employees in manufacturing industries	Thailand (2002)
	Less than 26 employees in wholesaler industry	Ranged between 26 up to 200 employees in wholesaler industries	
	Less than 16 employees in retailer industry	Ranged between 51 up to 200 employees in service industries	
	6 – 50 employees	51-100 employees	Brunei-ASEAN SMEs (2011)

	11-50 employees	51-100	Cambodian-ASEAN SMEs (2011)
	Ranged between 01 up to 49 employees in all sectors	Ranged between 50 up to 249 employees in all sectors	European Urban and Regional Studies (2001)
	Less than 50 full-time employees in all sectors	Ranged between 51 up to 150 employees in all sectors	Shankar (2010)
	Less than 150 employees categorised SMEs		Ha-Brookshire, J. & Dyer, B. (2008b)
	Less than 100 employees for all industries considered SMEs		Menegkop and UKM Law No. 9 on Small Enterprises of 1995
<b>Assets :</b>	Own assets of up to 50 million baths for manufacturing, wholesaler, and retailer up to 30 million baths for retailer industries	Own assets of 50 up to 200 million baths for manufacturing and service industries, 50 up to 100 million baths for wholesaler	Thailand (2002)
	50,000 – 250,000 (USD)	250,000 – 500,000 (USD)	Cambodian-ASEAN SMEs (2011)
	50.000.000 – 500.000.000 (IDR)	500.000.000 – 10.000.000.000 (IDR)	Indonesia-ASEAN SMEs (2011)
	Net asset less than IDR 200 million excluding land and building		Indonesia-Menegkop and UKM Law No. 9 on Small Enterprises of 1995
<b>Education &amp; skills:</b>	Generally high school educational background and diploma as well as lacks of productivity skill		Green <i>et al.</i> , (2002); European commission (2007) & Radiah Abdul Kader <i>et al.</i> , (2009)
<b>Annual sales turn over:</b>	Annual turnover of not more than RM10 million 300.000.000 – 2.500.000.000 (IDR)	Annual between RM10 and RM25 million 2.500.000.000 – 50.000.000	Malaysia (Shankar, 2010) Indonesia-ASEAN SMEs (2011)
	Not more than 100,000,000 \$		Singapore-ASEAN SMEs (2011)
<b>Locations :</b>	Most of SMEs operated in rural area		(Tambunan, 2009; Radiah Abdul Kader <i>et al.</i> , 2009 and Donald C & Carl Liedholm, 1998)
<b>Start up capital</b>	Most of SMEs use their own saving		Author survey(2011)
<b>Number establishments</b>	Dominating in numbers		Literature



### **3.3 Distribution channel**

David Revzan (1967) clarified that the word “channel” was derived from a French word for canal. It is a lane that goods pass through as they are moved from points of the origin to the points of the intermediary and/or final destination. “In these flows, the intermediary could be a series of marketing agencies, namely the wholesalers and retail middlemen, who guide the goods in the various combinations of marketing functions at various points in the channel in order to facilitate the goods to flow smoothly from one point to another within the channel”. Converse (1921) mentioned clearer that “the various middlemen who handles goods between the producer and the consumer constitute the trade channel” (p.62). A more comprehensive definition is stated by Vaile *et al.*, (1952): “A channel of distribution may be the combination and sequence of agencies through which one or more of the product flows. Agencies are differentiated from each other according to the combination of flows in which they come into the picture, and the part of the flows for which they take responsibility” (p.121).

However, Bowerox *et al.*, (1986) briefly explained that distribution channel is also defined as a grouping of intermediaries who took part in guiding a product throughout the process of flow from the initial point of the producers to the end customers.

#### **3.3.1 The origin of distribution channels**

David Revzan (1967) said that human culture was naturally characterized by an assortment of goods. The activities of sorting goods, for instance, arranging clothing, stocks of foods, fuel, kitchen utensils, and other items, were aimed to fulfil the needs of individuals either for personal or family usage. Therefore, each item in the assortment could be considered as a tool which was designed for their typical usage. The purpose of good assortment activities

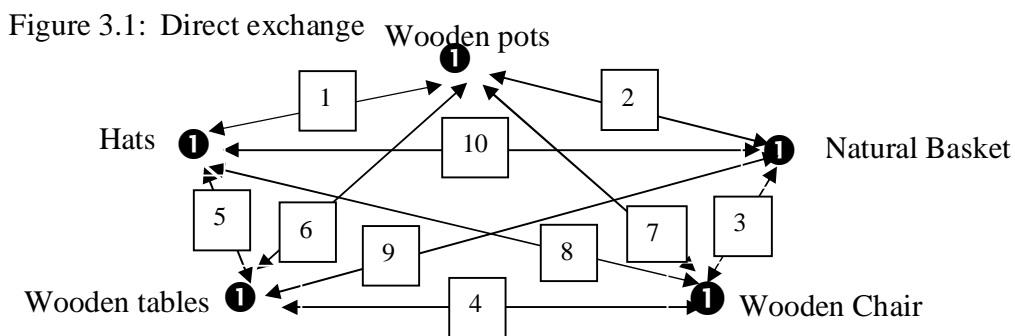
was then to facilitate various kinds of activities for them, which would be expected to be implemented.

In general, he viewed that in daily activities, people were normally demanding to be equipped with suitable goods for all their activities, which would surely suit to their culture. Therefore, if any item of the goods in their fundamental assortment was almost used up, they would be eager to replenish them. However, when their condition changed and they need other additional assortments, they would tend to collect new items of goods in their inventories. The example of this change could be seen from bachelorhood to married life. He pointed that in both primitive and/or advanced cultures, the individual and the household would maintain their needs by developing the assortment of goods in their belongings (David Revzan,1967).

Nevertheless, he further explained that in a primitive culture, most of the family members produced their own goods to fulfil their needs. Here, the term “produce” means not only in manufacturing activities, but also in collecting natural resources that do not belong to someone else. At an earlier level in the economic activity development, it was explained that some of the needs of a household could be fulfilled more efficiently by an exchange rather than by own production. In these terms, one family could be more skilled compared to another. The example of these could be seen in the illustration of making natural baskets and wooden pots. If each of the families produced a surplus of the goods, then, they would engage in exchange (David Revzan,1967).

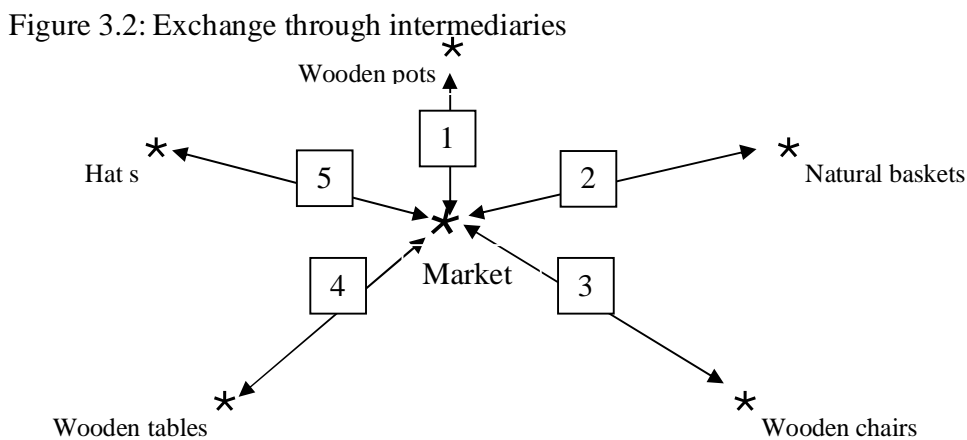
### 3.3.2 Exchange through intermediaries

Alderson in 1967 mentioned that specialization in manufacturing would give more benefit for an exchange. A clearer illustration could be described as follows: if there are five people and each of them is manufacturing a surplus of goods which are needed by all of them; the goods are for instance wooden pots, natural baskets, wooden chairs, wooden tables, and hats, and in each case, a surplus of five units of goods is manufactured and are exchanged, ten separate exchanges then would be needed, as illustrated in Figure.3.1.



Source : Wroe Alderson (1967)

From Figure 3.1, if suppose this pattern of decentralized exchange would be replaced by a central market, all the manufacturers would come together to an appointed place as pictured in Figure 3.2 below. As seen in the illustration, only five trips are needed, instead of ten.

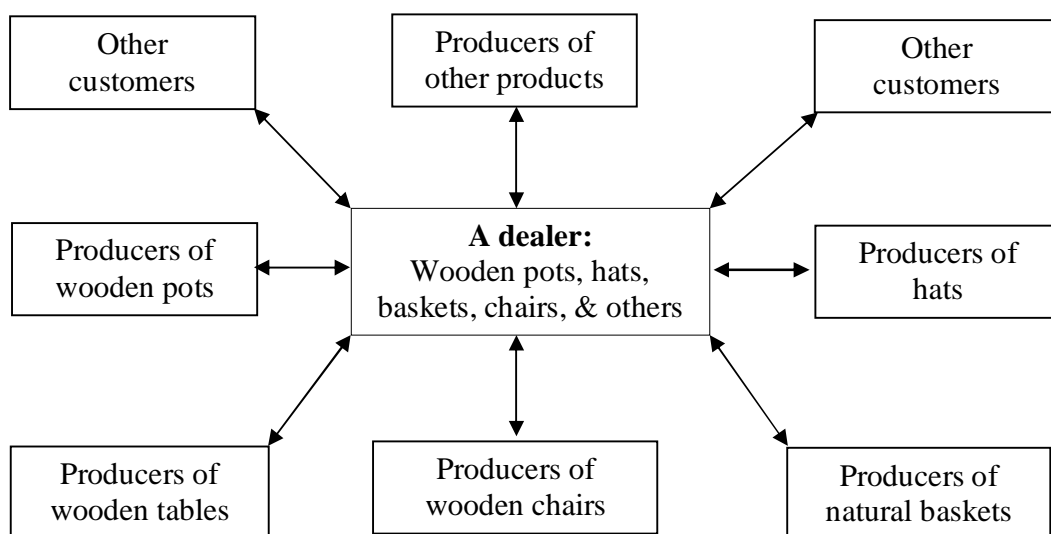


Source : Wroe Alderson (1967)

### 3.3.3 Centralized exchange and creating utility

The next step in the development of the exchange is conducted by a dealer. David Revzan (1967) explained that all producers, namely, producers of wooden pots, natural baskets, wooden chairs, wooden tables, and hats, are now, involved in an exchange with a dealer rather than involved with one another. For example, the natural basket maker, in order to refill the assortments, he exchanges the surplus with the dealer. In return, he receives the needed goods to refill his assortment. By engaging in such exchange, the items of wooden pots, wooden chairs, wooden tables, and hats could be obtained in one single transaction rather than in four separate transactions. In this way, as seen in Figure 3.3, the involved parties can achieve effectiveness and efficiency (David Revzan, 1967).

Figure 3.3: Exchange through a dealer



The simple model of exchange, as seen in Figure 3.3 above, is called “possession utility”, as well as “time and place utility.” He mentioned that in these activities, the effort was made in the act of the exchange itself. Hence, the dealer had created possession utility by

bringing about the relocated goods from the producers to its consumers (whoever needs the goods) with less effort than would be required in direct trading (David Rezan, 1967).

According to Walters (1977), utility is defined as the ability of products to fulfil human satisfaction. In this context, utility could be seen as a basis of all economic value. Walters (1977) places utility into four categories: form, time, place, and possession utilities. Form utility is any change made in order to add value to the product. Normally, the process involves any production process in terms of determining the type of material used, determining the chemical content, changing the size, shape or other dimensions of the finished good or changing the method of construction from their original material. On the other hand, time utility is to have the goods whenever the customers wanted to own them through purchase. In this case, a product has its purposes to consumers if it was made to be available when it was needed, otherwise time utility could not be achieved. Storage could be considered to create time utility. The channel helps create time utility of the products through inventory in warehousing. Last but not least, place utility is having the products at the location desired by customers. A consumer could not derive satisfaction from a product in some distant location. Thus, for example refrigerators stock piled at the place of production serve no economic function for consumers until moved to the market, and finally, to their homes. The channel creates place utility by means of transportation. Possession utility refers to all activities necessary to change the ownership of goods (Walters, 1977).

### **3.3.4 The role and importance of distribution channel**

Peter (1980) pointed out that the main objective of distribution channel is to connect the gap between the point of production and the point of end of consumption. It is from the

need of consumers, together with their demand, that actually sets up the whole process of the goods flowing to the consumers. Therefore, the flow of goods is to carry out the need of the customers for getting the goods at the right time and place at the agreed price. In this case, an efficient and effective transportation is a key factor. The raw materials should be transported to factories, and furthermore, finished goods should be dispatched to wherever they are needed within easy reach of consumers.

#### **3.3.4.1 The geographical gap**

Peter (1980) mentioned that in daily practices, mediators could even enhance the efficiency and effectiveness of exchange when the location between the producers and consumers are still under the same community or nearby. In this context, the compensation becomes larger when large distances mediate between them. Therefore, for example, when the pot maker and the natural basket maker had been separated hundreds or even thousands of miles apart, place utility would take a new aspect in this case. Thus, in order to fulfil the utility, one or the other should have the initiative to connect the gap between the producers/sellers and its consumers. Other parties must also realize the emerged cost of goods flowing. Transportation and communication system bridge the distance. The railroads and trucking companies are in effect with the new types of specific intermediaries, serving buyers and sellers more cheaply than before.

#### **3.3.4.2 The time gap**

The manufacturers and the consumers could also be separated extensively in time. Here, for instance, strawberries ought to be transferred to the consumer immediately, otherwise it will perish. Even though such a product could be distributed in canned or frozen, they still need a suitable and perhaps specific handling before reaching the consumers. Another

example is the wheat crop which is harvested and intended to be consumed as bread or other food stuffs. Here, the retailers or the whole sellers would generate time utility by holding the stocks of goods to be available for buyers. Without these facilities, the only way to deliver them to the buyers when they need the product would be to place an order with the producer or wait until the product could be produced and delivered (Peter,1980).

As goods flow from the point of producer or manufacturer to the point of consumer, they would be handled by various institutions, distributors, agents, or retailers. On the other hand, due to transportation and handling cost (and the distributors' profit), the goods could increase in price. However, the increased price is acceptable for the distributors to fulfil an essential function, which is helping to give the consumers an easy access to goods. The end result of the distribution system is that a wide variety of goods and services is readily available to every consumer (Peter,1980).

### **3.3.5 Integration in distribution channel**

According to Root (1964), and Ramaseshan, and Patton (1994), the integration of distribution channel is determined by the second channel location. If the second channel, which is linked from the producer (manufacturers) is located in the producer's country, it is considered as an indirect channel. On the other hand, if the second channel is located in the importer's or buyer's country, it is named as direct channel (integrated channel). In this case, despite independent middlemen or agents/distributors that might have been used, if they are located in the buyer's country, they are considered as direct channel (Root, 1964). This has been consistent with the classification used by Root (1964), whereas Albaum *et al.*,(1989) stated that indirect exporting takes place when the exporting manufacturer use independent organizations located in the producer's country and direct exporting occurs

when a manufacturer or exporter sells directly to an importer or buyer located in an overseas market area.

### **3.3.5.1 Vertical integration**

Williamson (1983, p.104) stated that “an economic transaction cost is relatively concerned with market efficiency. It is a disintegrated structure versus “hierarchies” or an integrated structure that mediates the transactions. The transaction happens when a good or service is transferred across separable interfaces”. There has been an assumption of a theory that supports integrated or non integrated structure of the distribution channel. He indicated that in spite of the intentions to be rational (bounded rationality of human), human or agents have limitation capabilities in complex problem solving. It further assumed that human agents are often unfair in order to protect or maximize their self-interests. The above theory implies that there should be more integrity in economic transactions.

Williamson (1983) further suggested that the high level of frequency in transactions would increase efficiency. He proposed that great investments would usually be supported by bilateral integration, for instance franchising (Williamson, 1979). Therefore, it was claimed that the integration of the whole selling and retailing processes are driven by high quantum financing. He also suggested that marketing channel integration is aimed to control potential risks. Certain distributors might debase brand quality by capitalizing the efforts of the manufacturers. In this way, the distributors are able to perform better without paying the price. He also mentioned that ownership integration is usually established for products requiring great assets-specificity requirements.



A relevant conceptual framework was introduced by Anderson *et al.*, (1983). Looking at the economic transaction costs, it has been used for analyzing the vertical integration in the context of marketing, such as the integration of the cost of advertising, selling, distribution, marketing research, and so forth. They described that vertical integration could control reductions in the net effectiveness that resulted from the opportunistic behaviour of independent marketing agents. Such behaviour could cause lack of competition among these independent agents relating to asset specificity and economies of scales as an entry barrier, environmental uncertainty, inability to monitor performance, and free-riding potential.

On the other hand, according to Klein *et al.*, (1978), they argued that the purpose of vertical integration is to prevent financial losses posed by transaction-specific assets. For instance, long term contracting could reduce the incentive for opportunist behaviour. Williamson (1992) suggested that when buyers post a collateral bond equal to the value of the specific assets held by sellers, the hold-up problem could be mitigated. One way to reduce or avoid the hold-up problem is by vertical integration.

In addition, Stern, and El-Ansary (1988) emphasized on the bigger advantages of using integrated (direct) channels rather than independent (indirect) channels. These were more assured by Jensen, and Meckling (1976) in an independent channel strategy, when the producers should provide a high level of both “before and after sale service”, using independent channels. This has been considered more difficult and costly because of the difficulty of the manufactures to ensure that the independent channel is able to provide the service as specified in the contracts. When sales relationship requires a particular

knowledge, skills, or difficult responsibilities, direct channels (integrated channels) are found to be more effective. In this case, firms could decide to work towards solving their problems by replacing their distribution agents (Anderson, & Coughlan, 1987; Klein *et al.*, 1978; Williamson, 1981). Furthermore, integrated channels generally provide the manufacturer with more control, and at the same time, controlling the responsibility, commitment, and accompanying risks (Ahmed, 1977; Czinkota, & Ronkainen, 1988).

### **3.3.5.2 Non integrated channels**

Root (1964), in Ramaseshan, and Patton (1994), defines indirect channel as a channel network where the first channel or manufacturers and the wholesalers or the second channel are located in the same country, while the others are in overseas or domestic. However, there were many positive perspectives of the indirect channels that could be seen. According to Anderson, and Coughlan (1987), by joining the non integrated channels, it could help the small businesses to solve the disadvantageous negotiation of freight rate. Hence, it allows the manufacturers to minimize customer knowledge about foreign marketing particulars (Anderson & Coughlan, 1987), and lowers the cost of exporting due to the economies of scale (Anderson, & Coughlan, 1987; Angelmar, & Pras, 1984).

Furthermore, Coughlan (1985) added that establishing independent channels is more profitable for the producers rather than establishing the integrated channels. This is due to the fact that market competition makes manufacturers to be more competitive by selling the product indirectly in order to reduce transaction costs. Utilizing indirect channels also could avoid some of the problems of office politics and achieving actions through threats (Anderson, & Coughlan, 1987). Other advantages of using an independent intermediary is it allows manufacturers who had in mind to enter the global market more opportunities in

utilizing a distribution specialist, such as the benefits of the economics of scale and the scope that the intermediaries obtained by pooling the demand for the distribution of services of several manufacturers in the foreign market (Williamson, 1981). Furthermore, by using an independent channel, producers could avoid some of the disabilities of bureaucratic governance structures, especially, the organizational politics (1979).

Moreover, Lilien (1979) found that most firms in US (Fortune 500 firms) tended to use independent channels for mature (older) products. Older product categories were more likely to be distributed through independent channels than the newer ones because the older ones were more established and already well known. The independent channels also gave more space for the manufacturers to find pools of qualified (knowledgeable) independent agents to choose from and could possibly replace non-performing agents.

Even though the use of indirect channels would provide many benefits, Miller (1982) found that the age of firm was a factor in applying that the policy to use an indirect channel as it became more difficult when firms have already established export sales. Hence, the decision of switching to an indirect channel should be followed by creating significant incremental sales. However, a recent study by Anderson, and Coughlan (1987) indicated that product age did not have a significant impact on channel choice. Using independent channels also could make the product more successful in the overseas market due to availability and flexibility. On the contrary, producers whose products did not fit into easy or broad classifications were found to have more problems finding an independent channel that worked effectively (Bello, & Williamson, 1984).

The study by Wortzell in 1983 indicated that some intermediaries for instance, export trading companies (ETC), could contribute towards the export success of exporting nations like Korea and Brazil. ETC could facilitate a tremendous and simple opportunity, especially for small businesses to get involved in export activities. Rao *et al.*, (1983) found that increased practice of export agents was the second most popular approach engaged by small businesses to expand exports during the recessionary period. In this case, the use of an independent channel had been considered the best choice due to the differences in selling in overseas involving culture and language that could not be found in the domestic market. However, when the problems of currency exchange rate, tariff, tax, and local laws were added, the difficulty of the situation became more evident.

Further study by Anderson, and Coughlan (1987) found that firms were often not convinced to utilize integrated channels in countries which had dissimilar cultures from their own. Bello *et al.*, (1984) assured that this was because many firms encountered difficulty in extending their official channels into international distribution for instance operating their own distributors or retailers overseas. They frequently delegated non integrated channels, such as foreign mediators to infiltrate global markets.

### **3.3.6 Distribution channel institutions**

Walters (1977) provides the definition of channels as “A team of merchant and agents that combines physical and title movements of products in order to create useful assortments for specified markets” (p 4-5). Anyhow, the channel of distribution could not be explained in a short space. Therefore, it is necessary to explain the relationship between the channel members in order to clarify the members’ differences. However, there are two types of marketing institutions that make up any channel distribution; merchant and agent

middlemen. The term merchant is used to designate businesses that are in the direct line of the product ownership.

There are three major types of merchants; manufacturers who make products, wholesaler who sell to other businesses, and retailers who sell to households or end users.

One of the most confusing aspects of marketing channel is related to wholesaling. The US Bureau of the Census, in Louis *et al.*, (1982) defines that wholesaling is concerned with the activities of those persons or establishments, whereby goods are sold to the retailers and other merchants, and/ or to industrial, institutional, and commercial users, but do not sell in significant amount to ultimate consumers. According to Walters (1977), for the sake of customers, a wholesaler can often provide services in order to anticipate late deliveries or do quick deliveries for the needs of customers. Hence, they are usually located closer to the end users than manufacturers. In terms of ownership, most of the wholesalers take title to the goods they stored, therefore, the cost of inventory for the customers would be in the wholesalers' expense. In terms of financing the exchange process, it is financed by wholesalers by investing the inventory and extending credits to the customers. In terms of risks, wholesalers assume risk when they take possession and ownership of products that can weaken or become obsolete. In terms of negotiating, wholesalers generally bring together an assortment of merchandises, usually related items, by negotiating with a number of different resources. While in terms of ordering, a wholesaler can anticipate his customers' needs, and thereby, simplify their buying tasks. Rather than having to negotiate and purchase from a large number of sources, a customer can order from one source the assortments of products required (Walters, 1977).

“Agent middlemen or agents are defined for our purposes as institutions that perform for merchants some specialized service or function related to the sale or distribution of goods, but who do not take title to the products in performing this service” (Walters, 1977, pp.115). Here, agents could operate at all levels in a marketing/distribution channel. Agents could act like merchants. They act all activities of the goods’ movement from producers to consumers, but they never own the goods. Therefore, here, agents do not take title of the goods (1977). The agents could be divided into two major groups by purpose; facilitating and supplemental agents where facilitating agents are specialized in some aspects of the movement of goods and services from producers to consumers, while supplemental agents also derive their name from the nature of their responsibilities. It comes from the word to supplement that means to add something, especially to make up for deficiency. This kind of agent performs services to the institutions in that channel that could not be performed by themselves due to shortage of resources. Hence, this agent does not go between producers and consumers. It must be understood that sometimes, agents could hire other agents (Cateora *et al.*,1975). For example, an advertising agency could hire radio and television like the advertising department of a company and transportation company, and others.

Furthermore, Bridman (1962) explains that the retailing treatment is actually grouped into six broad categories: total retail stores, width of the products, retailing ownership, and retailing operation characteristics. Here, retailers are defined on the basis of whom they sold the goods to. Thus, retailing involves all the marketing activities related to selling to final household consumers. A retailer is a merchant whose main business is to serve the ultimate customers. One of the methods that could be used for retailing classification is by

getting the width of the product line. Based on the width of the product line, retail stores could be divided into specialty stores and departmentalized stores. The speciality store, one of the oldest forms of retailers, sells a single or narrow line of merchandise such as shoes, dresses, records, candy, furniture, groceries, or novelties. Departmentalized retail stores are far fewer in numbers than speciality stores, but they make greater impact on retailing when measured by volume of sales. This class includes the traditional department store, discount department house, supermarkets, and variety stores.

Walter (1997) further clarifies that based on the number of stores, retailers can be divided into independents, branches, and chain stores. Independent is a term reserved for the ownership and operation of a single store. Most independents are small, and most retail stores fall into this category. Chain stores are originally defined by the census as four or more stores under one management offering a similar line of merchandise.

### **3.3.7 Distribution channel performance**

According to Borgstrom (2005), in distribution channel, as part of the supply chain network, the institutions should be established to achieve in relation to the network's needs, in which only having efficiency orientation has become insufficient. Hence, effectiveness would lead to the network's relationship performance. It means the aim of the firms should involve the need of partnership among channel members. According to Moller *et al.*, (2003), efficiency is referred to a cost, while effectiveness is referred to the advantage of customers within the supply chain. This implies that efficiency improvements could be achieved via for instance, just-in-time production, while effectiveness through customer orientation.

Furthermore, Pfeffer, and Salancik (1978) argue that efficiency and effectiveness are constructs that should be seen in separate dimensions as they are independent of each other from a resource dependence perspective. Liljegren (1988), on the other hand, suggests that these constructs are interrelated and complex from an industrial network perspective. Recent development of these constructs was conducted by Håkansson, and Prenkert (2004). They have been described as a unidirectional influence. It means, effectiveness is dependent on efficiency. Further result of a study by Corswant *et al.*, (2004) indicated that in reality, the supply chain could be effective, but inefficient. An example of this is when suppliers maximize exchange value to the chain with poor organizational efficiency (Corswant *et al.*, 2004). Meanwhile, a recent study by Borgstrom (2005) showed that in terms of value chain, efficiency and effectiveness somehow are interrelated with each other.

#### **3.3.7.1 Distribution effectiveness.**

According to Pfeffer, and Salancik (1978), organizational effectiveness is defined as an external standard “of how well an organization is meeting the demands of the various groups and organizations that are concerned with its activities” (p.11), whilst Hines *et al.*, (2000) emphasize on a contract for doing the right things or having validity of outcome.

In addition, Håkansson, and Prenkert (2004) define effectiveness as being referred to the use of value. This value then could be used for an evaluation of the network’s utilization. They further explain that in resource dependence perspective, effectiveness is seen as an independent measure for evaluating organizations. However, supplies are effective if they deliver what was asked for. In supply chain management research, effectiveness is viewed equalized with supply chains’ flexibility and agility to customer demand, in which, in this



case, it refers to time delivery. Hence, ineffective supply chains are loosely integrated with poor management of existing interdependencies. Effectiveness, by definition, is a qualitative measure set by the evaluator.

According to Walter *et al.*, (2001), in the supply chain context, the performance of channel members could be measured based on relationships. The productivity is compared to the competition offered rather than being evaluated by the relation to customers and their customers' demand. However, in practice, the performance of channel members is decided by the evaluator, who is interdependent with the suppliers, that is influenced by the relationship, by the supply chain, and by the network. Effectiveness is created in a relationship in a process of attention to different interdependencies, i.e. the evaluator is influenced in its evaluation. The evaluator would propose that effectiveness, as a use value in a supply chain, a combination of indirect benefits gained through the suppliers and the suppliers' networks.

Plus, according to Rhea, and Shrock (1987), in measuring distribution effectiveness, the channel members should refer to the customer expectation of the distribution activity, in which, if the service is given by the channel exceeded or equal to the expectation, satisfaction has occurred. For example, if the customers demand delivery order within two weeks and the company is able to deliver in two weeks or less than two weeks, it indicates that the customers' expectations are fulfilled and the other way around.

### **3.3.7.2 Distribution efficiency**

According to Bruce (1967), marketing expenditures usually consist of 40% of the total product cost to ultimate users. The final cost, then, is calculated by the marketing cost of the manufacturers added by the total cost of the involved activities in distribution channel (middlemen/distributors/agents). A high degree of efficiency is crucial in marketing for a significant share of the cost which may occur. Therefore, considering the distribution cost is essential for its characteristics once it is established and it is usually difficult to change.

He further described that a distribution cost itself could be classified into two broad areas: cost analysis and cost controls. Distribution cost analysis is comprised of identifying the costs and the profitability of carrying various distribution channel activities. The activity of finding cost information could be used to discover more effective and more profitable ways of distribution channel. Distribution cost control, on the other hand, is the measurement of performance in the marketing fields against predetermined standards and the execution of corrective action to eliminate unfavourable deviations. Cost analysis is concerned with management planning, while cost control is concerned with seeing that the actual coincides with the planned strategies (1967).

The definition of organizational efficiency itself is defined by Pfeffer, and Salancik (1978) as an internal standard of performance and approximately a construct “for doing the things right”. From the point of view of resource dependence, efficiency is an independent measurement to evaluate the productivity of the organization, for example, output produced per resource utilized should equal 100% inclusive of losses. Therefore, efficiency can become a suitable measure for such a closed system’s output, for instance, as an

organization from a machine-bureaucratic perspective when the produced output is the same as profit.

However, Håkansson, and Prenkert (2004) have conceptualized efficiency in distribution channel as part of the supply chain based on a dyadic system's exchange value. They evaluated the terms based on two factors regarding the activity system's utilization of resources. For example, efficiency could be achieved in delivery, but not in inventory costs. Efficiency, is thus, a quantitative, as well as a qualitative evaluation, in a supply chain as goals have to be negotiated. The efficiency is therein, described as a compound evaluation of quality, delivery, cost, and overall capability that is not only planned and reviewed in the relationship, but it is also a measure of the relationship. Besides, the efficiency of a producing/using system is influenced by serial interdependencies through a number of relationships. This implies that losses in an evaluation of one firm is efficient to the supply chain.

Meanwhile, Ruckert *et al.*, (1985) define efficiency as how cost effective a society's resources are being used or in other terms, they define efficiency as the relationship between the outputs of the organization with its input. According to Farrell (1957), a firm's efficiency might be defined as a firm's capability to produce a given certain output level at the lowest possible cost. Abdulai *et al.*, (1998) stated the concept of efficiency could be categorized into technical, price or a locative efficiency. It could be further explained that a firm is technically efficient if he is able to produce more outcome or output from the same quantity of inputs than other firms could do or in other words, a firm is able to use the minimum feasible level of inputs to produce a given level of output. A locative efficiency,

in contrast, is the degree to which a firm makes use of inputs in the best proportions, given the observed input prices (Coelli *et al.*, 2002).

### **3.4 The concept of innovation**

Literatures in general have explained how innovation leads to performance. Nonetheless, several definitions on innovation have been given by scholars in global literature. Urabe (1988) defines innovation as the formation of a new idea and its execution into a new product, process, or service, which would lead to the active national economy's growth, rise of employment, as well as profit creation, for the innovative profit-oriented organization or firm. On the other hand, Utterback (1994) provides a clearer definition of the innovation concept both in terms of product and process innovation. He defines product innovation as the extension or introduction of new or improved products or services which are successfully accepted in the market, whilst innovation process is involved in the implementation of new or improved methods of manufacture, distribution or delivery of service.

However, Hargrave *et al.*, (2006), and Kotler (1991) define management innovation in separate dimensions. They define management innovation as those activities that are engaged in the preface of changes in management, organization work, and the working conditions, and skills of the workforce that could yield better results in effective usage of human and physical resources. Another definition of innovation defined by Damanpour *et al.*, (1989) is a concept that is related to new or different ways of doing things to fulfil both social and organizational objectives.

Other scholars, like Johnson (2001), emphasize the difference between innovation and invention. Invention stresses on the participation of novelties rather than scientific and technological developments, such as a new marketing strategy or recruitment policy, whilst innovation does not necessarily involve the creation of novelty, but it might be borrowed or learnt from others, then adopted or implemented. This is also considered as innovation, as long as it is perceived to be new for the unit of adoption. According to Zaltman *et al.*, (1973), an innovation is: “...any idea, practice, or material artefact perceived to be new by the relevant unit of adoption” (p.10).

Furthermore, Rogers, and Shoemaker (1971) stated that “An innovation is an idea, practice, or object perceived as new by the individual. They stated that as long as human behaviour is concerned if an idea is 'objectively' new as measured by the lapse of time since its first use or discovery ...” “If the idea seems to be new and different to the individual, it is an innovation” (Rogers, & Shoemaker, 1971, p.19). The issue of whether innovation should be approached as a one-dimensional or multi-dimensional model has been debated by Cooper (1998), who opinionated that in practice, innovation often occurs in many simultaneous forms. However, Venkatraman (1991) defines innovativeness as a personality trait representing an individual’s enjoying for novelties. This approach is preferred because implementation of novelties is more tangible, more objective, and thus, more measurable than an individual's personality. Besides, it is also in line with the definition of innovation by Rogers and Shoemaker (1971), Zaltman *et al.*, (1973), and other scholars.

### **3.4.1 The types of innovations**

The concept of innovation has emerged not only to be correlated with products and processes, but also related to marketing, organization, and other kinds of activities. According to Oslo (2005), in Gunday (2011), the concept of innovation is distinguished into four types; product innovation, process innovation, marketing innovation, and organizational innovation. Product innovation is defined as the introduction of a good or a service which is new or significantly enhanced concerning with their characteristics or intended uses, significant improvements in technical specifications, components and materials, incorporated software, user friendliness or other functional characteristics. From the brief points mentioned earlier, it could be concluded that either product or process innovations are closely related to the concept of technological developments.

Product innovation itself might make use of new knowledge or technologies, or might refer to the combinations of existing knowledge or technologies. The definition of product in these terms would include goods and services. Product innovation is a complicated practice, triggered by advancing technologies, developing customer needs, reducing product life cycles, and improving international contest. Hence, a firm's success should involve relations within the firm, its customers, and suppliers (Akova *et al.*, 1998).

On the other hand, according to Oslo (2005), in Gunday (2011), the implementation of a new or significantly enhanced production or delivery method, includes significant changes in techniques, equipment and/or software, is called process innovation. Process innovations could be planned to reduce unit costs of manufacturing or deliverance, to enhance quality, produce or deliver new or significantly enhanced products.

Other types of innovations have been addressed by Kotler (1991). Marketing innovations are strongly related to pricing strategies, product package design, product placement, and promotion activities, along the lines of four Ps of marketing. On the other hand, an organizational innovation is the implementation of a new organizational method in the firm's business practices, workplace organization or external relations. Organizational innovations have the tendency to increase a firm's performance by reducing administrative and transaction costs, improving work place satisfaction (and thus labour productivity), gaining access to non tradable assets (such as non-codified external knowledge) or reducing costs of supplies (OECD, 2005). The examples would be the introduction of practices for codifying knowledge by establishing databases of best practices, lessons learnt, and other knowledge, so that they are more easily accessible to others. This could be exemplified by the introduction of training programmes for employee development and improved employee retention or the initiation of a supplier development programmes. It could be concluded that organizational innovations are strongly related with all the administrative efforts that could renew the organizational routines, procedures, mechanisms, systems, and so forth, so as to promote teamwork, information sharing, coordination, collaboration, learning, and innovativeness.

Nowadays, literatures in management have also addressed changes focused from technological innovation to social innovation and social entrepreneurship (Dees, 1998; Nicholls, 2010). Westley, and Antadze (2010) explained that "social innovation concentrated on the processes and outcomes that change the basic routines, resource, and authority flows and beliefs of any social system". It means that skills and expertise used to develop successful commercial innovations can be used to solve a wide range of societal

problems that can be considered as social innovation. Murray *et al.*, (2010) define social innovation as ‘innovations that are social, both in their ends and in their means, specifically, (social innovations are defined) as new ideas (products, services and models) that simultaneously meet social needs and create new social relationships or collaborations. In other words, they are innovations that are both good for the society and would be able to enhance the society’s capacity to act.

### **3.5 Firm performance**

Firm performance is defined as the extent in which a firm can achieve success (Shankar, 2010). Morgan *et al.*,(2004) define economic performance of the firm as the point to which firms attain their outcome relating to the competitors in conditions of sales, market share, profitability, and sales returns from new products.

However, in respect to firm performance measurement, previous studies had engaged a diversity of financial instruments such as income, cash flow, return on assets and equity, and so forth to review a firm’s performance (Haber *et al.*, 2005). Meanwhile, Murphy *et al.*, (1996), in his 51 published entrepreneurship examination studies using performance as the dependent variable, found that most of the considered extent of performance are related to efficiency, growth, and profit. However, other studies have recommended the mixture of financial and non financial measures to propose a more complete assessment on firm performance (Venkatraman, & Ramanujam, 1986). Besides, according to Haber, and Reichel (2005), in addition to financial and non financial measures, there is another approach that focuses on internal and external measures. The internal measures are concerned with the interests of stakeholders in the firm, whereas the external measures focus on customers, suppliers, competitors, and other market-related indicators.



Kemp *et al.*, (2003), in Kim (2009), developed export performance by measuring sales per employee, value of export, total assets, and operation profit ratio. Besides, a study by Kim (2009) measured export performance adopted from Kemp *et al.*, (2003) by referring to the sales of manufactured products exported to other countries for sale or in terms of average of export sales. Similarly, a study by Deeksha Singh (2009) also adopted export volume as the export performance indicator (Deeksha Singh, 2009; Wilkinson, & Brothers, 2006). Kongmanila *et al.*, (2009), and Murphy *et al.*, (1996) extend export performance from export intensity, volume, and profitability.

### **3.6 Summary**

The comprehensive discussion of the major themes of this study, namely the concept of SMEs, product distribution channel, distribution performance, innovation, and firm performance from available literature, briefly address the following:

In terms of SMEs, various definitions are highlighted that conclude several indications. The number of employees appears to be the most adopted definition globally to categorize the business. It is also indicated that the more developed a country is, hence, the bigger the scale of SMEs to be related to the number of employees, sales turn over, and assets.

In terms of innovation, various definitions are also found to scope the innovation. Innovation is defined as the formation of a new idea that proceeds into activities, which, in turn, produce novelty invention in terms of product, process of goods or services, management, organisational structure, distribution, working conditions, and skills of the workforce that can yield better results in effective and efficient usage of human and

physical resources. From the various general conclusions addressed, it can be further defined that innovation is all new or novelty activities that are capable of guiding the value added process of tangible and intangible resources from the point of the producer to the point of end users to be more productive.

Distribution channel can be viewed as the flow process of resources from the point of producer to the point of end customer. However, throughout the process, resources value is sustainably improved. On the part of resources; tangible and intangible, commonly those which flow nearer towards the end customers tend to be more valuable than those further from the end customers. Hence, one enterprise usually cooperates with another (distribution channel members) in order to minimize transaction cost and improve distribution effectiveness and efficiency that will affect their firm performance.