منتدى الاستراتيجيات الأردني
JORDAN STRATEGY FORUM

Corporate Governance for SMEs

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Jordan Strategy Forum (JSF) is a non-for-profit organization, which represents a group of Jordanian private sector companies that are proactively engaged in promoting Jordan's economic growth. JSF's members are active private sector institutions, who play an integral role in public dialogue over economic and social issues. The Jordan Strategy Forum promotes a strong Jordanian Private Sector that is profitable, employs Jordanians, pays taxes, active in Corporate Social Responsibility (CSR) and supports comprehensive economic growth in Jordan.

JSF also offers a unique opportunity for its members to engage in evidence- based debate with the public sector and links them with decision-makers, in order to increase awareness, strengthen the future of the Jordanian economy, apply best practices and encourage private sector involvement in the decision-making process.

For more information about Jordan Strategy Forum, please visit our website at www.jsf.org or contact us via email at info@jsf.org.

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Contents

Introduction

With the advent of major corporate meltdowns like Enron, Siemens, Worldcom and Tyco in the late 20th century and early 21st century, corporate governance became a topic of heated debate in various countries. After introducing the Sarbanes-Oxley act in 2002 in the US, corporate governance became key in restoring the confidence of the public in large corporations and financial markets. Soon after, economies worldwide began the adoption of waves of regulations and measures that would prevent corporate scandals, hold firms accountable and enhance their performance, both ethically and financially.

The term corporate governance has been traditionally associated with large, publicly owned and traded companies, who are required, by law, to have formal policy on how executives take decisions and disclose business data. In essence, corporate governance is there to ensure equitable, fair and just treatment for all stakeholders, particularly in the free-market and capitalistic climate of the 21st century. The term is therefore synonymous with establishing rules and procedures to govern all aspects of business operation, in order to promote healthy growth and weaken corruption.

Sir Adrian Cadbury defines corporate governance as "the system by which companies are directed and controlled." Applying corporate governance precisely pertains to the authority structure of the firm. It ensures that it is the Board of Directors' (BoD) duties to pursue corporate objectives, while the firm itself diligently abides by the state's laws and regulations. Ultimately, the governance system of any firm serves the purpose of ensuring that firms are operated and managed in a manner that is "fair, equitable, and appropriate" for all stakeholders. Scholarly work has tied the adoption of good governance mechanisms with achieving the firm's objectives of better performance, market stability, higher investment, transparency and increased shareholder value.

In spite of its prevalence amongst larger firms, corporate governance remains a passing familiarity for the majority of SMEs. This is mainly due to the belief that compliance is costly and that corporate governance solely refers to publicly listed and owned companies that are governed through state endorsed codes. Also, governance systems applied to SMEs are internal and since SMEs are not enlisted in the stock market, regulators tend to have little to no influence.

For a SME, corporate governance is concerned with the roles of shareholders who act as owners and managers, as well as laying out rule and procedures related to ensuring the integrity of financial results. Assuming that the ultimate goal of every small business is to grow and be able to compete with larger and perhaps more established firms, numerous scholars agree that integrating corporate governance practices sets precedents for future growth and lays solid ground for potential investments and partnerships.

Literature Review

Publicly listed companies are associated with extensive literature and mainstream studies that deeply examine and evaluate the prevalence of governance mechanisms within their structures. An important component of the economy, which lacks this academic focus, would be SMEs. Some argue that corporate governance is not relevant in the SME context, due to the absence of a board of directors, and the unity of ownership and management. Nevertheless, most SMEs have business partners and multiple stakeholders with extensive interest in sustainable growth and long-term success. Benchmarking large and listed companies and following their best practices is a good first step towards responsibility accounting, and setting the standards for future employees and investors. Therefore, to assume that SMEs are simply a reduced replica of larger organizations is misleading and inaccurate, and therefore, new empirical and theoretical studies are required.

The importance of incorporating corporate governance mechanisms in such business structures stems from the fact that SMEs dominate most economies, particularly developing ones, and are the main source of employment and production. SMEs typically contribute as much as 85% of manufacturing employment, and account for over 90% of running businesses in most economies. Their presence cannot be overstated, and the absence of rigid and proper governance mechanisms may lead to failures in planning and growth. What further complicates the issue is that SMEs rarely comply – if at all – with the legislative requirements designed for publicly listed companies, and so it becomes the responsibility of the SMEs themselves and their immediate communities to design governance mechanisms that are intrinsically motivated.

In addition, it is reasonably well established that the culture of a SME is typically consistent with that of its leader, and this usually has important implications on constructing appropriate governance systems. Particularly in SMEs, a healthy governance system is not only needed to resolve agency conflicts, but it is in the interest of all stakeholders for it to exist, to ensure that all business processes are run with discipline. The level of information asymmetry in SMEs is very much lower than that in listed companies (or even non-existent), because owners of the business assets (shareholders) are simultaneously the managers, and so the agency theory is inapplicable to SMEs, as no conflict of interest exists between the shareholder and the manager (they are the same person). Rather, the stewardship model is more applicable and evident, in which the managers of SMEs, left on their own, will act as responsible stewards of the company assets they control, as opposed to what they will do in a listed company. The absence of the agency problem, and the dominance of the stewardship model in SMEs, is the most important factor in the context of the governance model. In SMEs, the focus shifts from aligning shareholder and manager interest, to motivating the manager (who is also the owner) into introducing a rational governance system determined by reason and not personal interests.

A key point to underpin would be that managers within listed companies are regulated within strict external mechanisms (PESTLE factors), as well as formal internal mechanisms (shareholder and BoD policies), and thus are rather restricted and disciplined in their domain. Leaders of SMEs on the other hand have more autonomy and flexibility in creating their governance framework, and it is thus important to ensure that these arbitrary governance policies do not spiral out of the boundaries of efficiency and healthy performance. As mentioned earlier, entrepreneurs of SMEs have significant freedom in shaping the governance system, and so the type of entrepreneur in question not only influences the organisational culture, but also has a direct impact on the structure of the governance system. The paper puts forth four hypotheses (backed with experimental data) with regards to how managers of SMEs influence the governance system.

First, when a manager/owner is the creator or heir of an SME, they have a major stake in the business, and consequently an intense ability to decide on the governance structures. When this is the case, governance mechanisms lose much of their meaning and effectiveness, as decision-making rests in the hand of an individual. Conversely, when the manager is an external recruit, they have much

Less of a say in shaping the governance system, and therefore power and decision-making is collectively distributed on the basis of what is logical and efficient. The governance system then becomes positively affected and usually imposes discipline.

Second, different leaders of SMEs have different and contrasting goals and agendas. The goal scheme of the leader is a direct influencer of the business culture, and as a result, a key determinant of the governance system. For example, an agenda focused on rapid growth and profit generation in a turbulent market fosters a culture of spontaneous decision-making and creativity, and a governance system based on "ends justify means". An agenda geared towards ensuring stability and sustainability fosters a culture of centralized decision-making and a governance system where reference to formal policy is required before taking action.

Thirdly, the level of professional experience and training the manager or leader of an SME has is also a key factor, which determines organizational culture and the subsequent governance system. A well-trained, educated and experienced manager enables for a democratic and participatory process in establishing a governance system, and this would be highly flexible and adaptive to surroundings. A less educated and trained manager/ leader would typically result in an authoritarian process of establishing governance mechanisms, and these would be rigid, centralized and totalitarian.

Finally, the level of formal education a leader or manager has received also influences the nature of the organizational culture and governance system in question. An educated manager or leader is likely to bring along a culture where accounting, market and financial data are utilized to aid decision-making. This promotes a governance mechanism where actions are guided by data and not formal power. The emphasis on scientific accuracy means that no single individual possesses absolute power, but processes are dictated by "cause and effect" analysis. A manager or leader with lower levels of formal education is likely to bring along a culture, where their hunch and intuition guide decision making, which encourages a governance system of centralized decision-making and constant consultation with whoever retains power

The why and why not?

A 2002 study by Hill and Knowlton showed that as much as 80% of Americans consider the ethical profile of companies when debating product purchases. It is reasonable, therefore, to assume that ethics are the backbone of governance practice, due to the high value it holds for customers and other stakeholders. Second, small businesses are unlikely to stay small for a long time, but are expected to gradually grow until they eventually make the change from private partnerships to public companies. Having an appropriate governance system in practice is not only a platform for steady growth, but is also an opportunity to capitalize on good reputation in legal and cultural arenas.

Generally, a successful governance system is holistic and addresses all stakeholders simultaneously, yet these typically have conflicting agendas and interest, which is a main challenge facing most businesses. Another equally important obstacle is that governance systems may quickly transform into parsimonious bureaucratic policies that hinder creativity, innovation and corporate entrepreneurship. This means that spontaneous and opportunistic entrepreneurship would be difficult to replace traditional departments of slow and risk- averse decision making.

Furthermore, corporate governance emerged in the first place as an attempt to mitigate the famous agency problem present in public companies, and because this is almost non-existent in SMEs, it is tempting to deem corporate governance as unnecessary in the SME context. This is especially that one challenge for its implementation may be that valuable time and money have to be spent on auditing, forming committees, board salaries, administration costs, etc… Also, the seemingly unfair implementation of governance policies would easily spark negative emotional connotations in the workplace, especially because complete equity and fairness is practically impossible.

However, there is an increasing global concern that calls for implementing governance systems in SMEs, due to their vast economic contribution and the benefits such system introduces. One benefit is improved accessibility to resources including better management decisions regarding sources of capital. In addition, accounting and auditing practices become more professional and in line with governmental requirements, as well as more accurate and representative of financial reality. This is extremely beneficial when it comes to investor attraction and public reputation. Infusing corporate governance into the structure of SMEs not only fosters discipline on the management level, but also provides key experience, which makes the process of growth and potentially going public much easier and smoother.

A corporate governance framework provides for a better more objective system and criteria when it comes to recruiting and retaining employees, ensuring appropriate mechanisms of performance evaluation and compensation. Such a framework also plays a great role in documenting actions and properly holding everyone accountable for their decisions, which contributes to investment protection and investor attraction.

How to implement corporate governance for SMEs?

After shedding some light on the importance of having governance systems in SMEs, the question which begs itself is who gets to establish the policies and processes that govern SMEs? In the case of large, listed and public companies, the procedures and policies are often dictated by legal requirements in and domestic legislation. However, SMEs are not subject to such company laws, and so a different approach needs to be taken when establishing a governance system. Setting up education channels that inform stakeholders, particularly those who work in the business, about what corporate governance is and why it is necessary is an important initiative. Basic knowledge about how governance systems work is equally important.

Mapping the current overall structure of the business in terms of job descriptions, communication channels, power hierarchy eliminates confusion and provides for intrinsic self-awareness as to how business operations and decisions ought to be regulated. Taking this step further and visualizing the route of growth the business would take allows for mimicking the best practices of larger companies and incorporating this with the business' attitude towards policy making and coping with growth.

Coding the roles and responsibilities of individuals is not enough, but all aspects of business operations and processes, such marketing, human resource management, financial reporting, risk management, public relations, etc… need formalization, so that official policy documents become the ultimate governor of processes. Establishing an advisory board comprised of unbiased third-party professionals, plays a great role in assuring the integrity and accountability of management practices, rational resolutions for conflicts of interests, and the overall transparency. Although the board would be predominantly composed of volunteers, careful selection of this board, making expectations clear, competitive payment and compensation, as well as critical awareness of consequent ethical implications, should be adequate enough to ensure the efficient monitoring and evaluation of activities.

Introducing a formal code of conduct, which illustrates the boundaries and limitations to which all employees are subject, and which ensures that all individuals are on the same page, is a key step towards having vision and mission statements as the main under pinners of policies and the main guiders of decisions. At the heart of corporate governance lies the importance of goal and objective identification, coupled with the appropriate strategies to achieve those goals. This provides focus, direction and guidance with respect to priorities and decision-making, and would thus formulate a governance system in accordance with the key set of goals at the time.

The most commonly used method of assessing how well individuals met their duties and how well business has met its targets would be financial reports and statements. Despite their limitations, preparing financial statements on a regular basis, especially with the supervision of external auditors, is extremely important when it comes to evaluating individuals and departments against their responsibilities and in assessing to what extent the governance system of business operations was adhered to.

In general terms, measuring or quantifying the success of governance systems in SMEs is unsurprisingly difficult. Whilst larger companies use shareholder satisfaction, legal requirements, and risk assessment as barometers to gauge the success of their governance systems, smaller businesses are not in the same boat, and so accurate assessment is typically done through stakeholder surveys and other primary research. However, the transparency and fairness that comes along cannot be overstated, and the benefits of regulating business activities with respect to a certain set of policies are also substantial.

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