

# Application of Corporate Governance Principles for the Sustainability and Competitiveness of Small and Medium Scale Enterprises: A Literature Review

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## Abstract

Literatures on the globe revealed that corporate governance practices and SMEs definition vary across nations based on the framework and cultural situation of countries under consideration. Besides, this difference can also be a result of different perspectives of policy-makers, researchers, practitioners, or theorists. Obviously, corporate governance is common for large and listed companies due to separation of ownership and control considering agency problem. On the other hand, issues of corporate governance for SMEs are possibly the most debated ones due to duality of ownership and control. However, the debates are not on the merits regarding need of corporate governance for the sector, rather on what are the appropriate governance norms and how to implement the same. Based on path of existed literature, SMEs can take the legal form of sole proprietorship, partnership or company. Pinning faith on this concept, it's advisable to set legal framework for the sustainability of SMEs. Accordingly, the purpose of this review was to put forward appropriate corporate governance principles applied to SMEs in general for their sustainability and competitiveness. Methodologically, this study is qualitative approach in nature employing secondary data in which document analysis of relevant empirical literature of published journal articles and review of different corporate governance theories were used to formulate the discussions. Hence, the author reviewed empirical literatures and corporate governance theories including fundamental and ethical theories to suggest applicable norms of good corporate governance for SMEs. Consequently, the review revealed that corporate social responsibility, compliance with rules and regulations, risk management, fairness and accountability, dispute resolution, Transparency and full disclosure of information, Internal control, and Internal audit should be applied and used as framework of governance by SMEs in general for their sustainability and competitiveness.

**Keywords:** CG Principles, CG Theories, Competitiveness, Ownership & Control, SMEs, and Sustainability

**Acknowledgment:** I thank my timeless brother-friend, Mesfin Beyene Abrha, LLB, LLM, Lecturer, Woldia University for his valuable comments and cheering me up by rising mesmerizing ideas.

## Abbreviations and Acronyms

ASX= Australian Securities Exchange  
COSO=Committee of Sponsoring Organizations  
CG= Corporate Governance  
CIPE=Center for International Private Enterprise  
AICPA=American Institute of Certified Public Accountants  
ACCA= Association of Chartered Certified Accounts  
CPA= Certified Practicing Accountants  
GDP=Gross Domestic Product  
OECD=Organization for Economic Cooperation and Development  
SMEs =Small and Medium Scale Enterprises  
IFRS=International Financial Reporting Standards  
CSA=Chartered Secretaries Australia

## Introduction

Globally, in both developed and developing countries, SMEs have been recognized as a driver of economic growth and development. Especially their role in income generation and economic growth for developing countries is critical (Ogechukwu & Latinwo, 2010). On the other hand, corporate governance has become a hot issue because of its immense contribution to the economic growth and development of nations (Maher & Andersson, 1999; Uchehara, 2017). This is due to the fact that, good corporate governance contributes to sustainable economic development by enhancing the performance of companies (Sarbah & Xiao, 2015). Recent empirical studies show that SMEs contribute to over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries (Abdissa & Fitwi, 2016). For this reason, many developed and developing countries as well as international organizations have come out with the guidelines for good corporate governance practices. Given

that all companies want to attain their objectives, corporate governance is relevant to organizations of all sizes. Nonetheless, the aims and nature of the corporate governance framework applied are likely to vary from one company to another (ACCA, 2015). Its nature and application may vary even across countries too (Zhang & Thiam, 2014). However, most of corporate governance guidelines focus on the public listed companies, not on small and medium sized enterprises (Abor & Adjasi, 2007; Htay & Salman, 2013). Because it is believed that the need for corporate governance arises from the separation of ownership and control in publicly held companies, supporting agency theory (Demeke, 2016). Besides, SMEs are businesses where owners may often be managers as well, or where company ownership may be shared across family members, in which there may not be separation of ownership and control, in case there may not be agency problem (ACCA, 2015). However, Literature across the globe suggests adoption of sustainable corporate governance norms within the SME sector since corporate governance contributes for the sustainability and competitiveness of SMEs (CPA, 2005; Develioglu & Hasit, 2013; Flowers, et al., 2013; Barnes, 2013). On the contrary, there are also strong arguments against introduction of such norms (Dube, Dube, & Mishra, 2011). For this reason, issues of corporate governance for SMEs are possibly the most debated ones. However, the debates are not on the merits regarding need of corporate governance for the sector, rather on what are the appropriate governance norms for the sector and how to implement these norms (Dube, Dube, & Mishra, 2011). Accordingly, previous research on corporate governance has viewed the dimensions of corporate governance from different perspectives and produced mixed results regarding their applicability (Afza & Nazir, 2014). Still, most of the studies were based on agency theory of corporate governance though there are many fundamental theories of corporate governance like Stewardship theory, Stakeholder theory, Resource dependence theory, Transaction cost theory, Political theory, Sociological theory on one hand and ethical theories of corporate governance including business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, and postmodern ethics theory on the other hand. However, Combination of various theories is best to describe effective and good governance practice rather than theorizing corporate governance based on a single theory, agency theory (Abdullah & Valentine, 2009). Therefore, based on the above background, this paper tried to suggest corporate governance principles to be applied by small and medium enterprises based on theoretical and empirical literature of corporate governance.

### **Literature Review and Discussion**

This review provides both theoretical and empirical concepts regarding corporate governance issues, SMEs, and good corporate governance norms for SMEs for their sustainability and competitiveness. SMEs are defined differently in different countries and different sectors too. Although there is no generally accepted definition of Small and medium scale enterprises, these enterprises have been long recognized as an instrument of economic growth and development (Ijeoma & Ezejiyor, 2013 ; Eferakeya, 2014). SMEs can take the legal form of sole proprietorship, partnership or company (Anzam, 2011). Usually they are owned by one person, or a small number of individuals. In addition, they are managed by owners, often owner/managers who make all the critical management decisions and undertake many of the management functions, such as financial management, personnel, marketing and production that might be distributed in larger corporation (Anzam, 2011). There are no hard and fast rules for developing formations standards of small, and medium size enterprises as every country has its own unique view and criterion (Yousaf, Jahangir, & Khalid, 2015). Accordingly, definitions of Small and Medium Enterprises vary from country to country even from sector to sector (Berisha & Pula, 2015). However, researchers believed that adapting international definition with slight modification considering the economic status of a country is logical (Esubalew & Raghurama, 2017). Among the variety of criteria used to define small business are total net worth, relative size within the industry, number of employees, legal status, value of products and annual sales (Afande, 2015). Based on some of these criteria, countries categorize enterprises as micro, small and medium. Besides, it is extremely difficult for researchers to compare findings from different micro, medium and small business studies due to the variation of defining SMEs. Normally, what is classed as small in one study may be medium in another and large in yet another study (Anzam, 2011).

Corporate governance is a mechanism for achieving maximum efficiency and plays a very important role in sustainability, productivity and profitability to meet the new challenges of quota free global environment (Makki & Lodhi, 2014). According to Saheed (2013), corporate governance is a network of relationships between corporate managers, directors, and providers of equity or stakeholders. Besides, corporate governance is a set of mechanisms, processes and relations by which firms are controlled and directed that is arranged to accomplish firm's objectives (Basyith, 2016). In addition to the above definitions, there are several definitions for corporate governance. However, the most appropriate definition which is more relevant to SMEs describes corporate governance as "a set of rules, regulations and structures which aim to achieve optimum performance by implementing appropriate effective methods in order to achieve the corporate objectives". In other words, corporate governance refers to internal disciplines or systems, which govern the relationships among 'key players' or entities that are instrumental in the performance of the organization. Moreover, it supports the organization's sustainability on the long term and establishes responsibility and accountability (Abou-El-Fotouh,

nd). History has revealed that there is a never-ending evolution of theories or models of corporate governance (Abdullah & Valentine, 2009). For this reason, there is no standard definition agreed upon by all economists, legal experts and analysts of the concept of corporate governance, which may be due to overlaps in many matters of organizational, economical, financial and social businesses, which affect the society and the economy as a whole (Al\_Sufy, Almbaideen, Al\_abbadi, & Makhoulf, 2013). In this regard, different theories have been emerged to understand the mechanism of corporate governance and provide different views and solutions (Afza & Nazir, 2014). Thus, according to Abdullah & Valentine (2009), these theories can be categorized as fundamental and business ethics theories of corporate governance. On the one side, fundamental theories in corporate governance began with agency theory, expanded into stewardship theory and stakeholder theory and evolved to resource dependency theory, transaction cost theory, and then political theory. Whereas, ethics related theories such as business ethics theory, virtue ethics theory, feminists' ethics theory, discourse theory and postmodernism ethics theory were built on the other side. Agency theory of corporate governance argued that shareholders, in any corporate business, possesses the right, but unable to have an influence to firm's operation policy. However, managers own the power of operation, but they do not hold the right of the firm and need not to bear the consequence and responsibility of the business decision, thus, there is agency problems that separated the power of firm and managers and cause the firm fail to achieve the goal of maximizing shareholders' profit. Precisely, managers work for the best of their own interest, neglecting interest of shareholders (Htay, Salman, Meera, 2013; Afza & Nazir, 2014; Abdullah & Valentine, 2009; Yusoff & Alhaji, 2012). On the other hand, Stewardship theory provides evidence in favor of management and put emphasis that managers work for the best interest of shareholders ( Patrick, Paulinus & Nympha, 2015; Htay, Salman, Meera, 2013; Afza & Nazir, 2014). Both theories, agency theory and stewardship theory, narrowed the concept of corporate governance to only two parties, management and shareholders, only. Subsequently, stakeholder theory is developed, considering all parties that have some relationship with the firm. More to the point, it explains that management has responsibilities to all the company's stakeholders not only towards shareholders. In view of this, stakeholders include government, investors, communities, customers, political groups, employees, trade associations, suppliers and others (Jones, Felps & Bigley, 2007; Ping & Andy, 2011; Abdullah & Valentine, 2009 ; Yusoff & Alhaji, 2012 ; Afza & Nazir, 2014). For the reason that the above theories only provide the insights to the shareholders, managers and stakeholder perspectives, other theory, resource dependence theory, explains that company needs several resources for the completion of its operations successfully which is not possible without the assistance of directors or board members. Indeed, based on this theory, board directors' primary function should be providing resources needed by the firm, considering managers as resource providers, to outshine in a competitive business environment to date (Abdullah & Valentine, 2009). Thus, directors/managers should bring resources to the firm, such as information, skills, business expertise, and access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy to create linkage of the firm with the external environment. Further, transaction cost theory of corporate governance elaborates the managerial opportunism related to external and internal business transactions and managerial behaviors towards the usage of these transactions for their self-interests. This theory assumes that corporate governance frameworks are based upon the net effect of business transactions (internal and external) rather than the traditional view of contractual relationships outside the firm with shareholders (Afza & Nazir, 2014). Moreover, political theory incorporates the ownership structure and political role of government in organizations. The major concern of this theory is how ownership is distributed between the shareholders of a firm which may influence the decision making of the firm and its corporate governance structure (Yusoff & Alhaji, 2012). Another theory, Sociological theory, however, explains the equitable corporate power distribution in the society and socio economic role of organizations. It assumes that outside dominated boards, transparent accounting disclosures and corporate accountability are effective and essential tools to promote impartiality and fairness in the society which are considered as the socio-economic objectives of a corporate firm (Afza & Nazir, 2014).

In addition to the above fundamental theories of corporate governance, there are also other ethical theories of corporate governance including business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, and postmodern ethics theory (Abdullah & Valentine, 2009). Business ethics theory is a study of business activities, decisions and situations where the right and wrongs are addressed ( Nainawat & Meena, 2013; Kulkani & Maniam, 2014). The main reasons for this perspective are the power and influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society, in terms of jobs, products and services. Besides, business collapse has a greater impact on society than ever before and the demands placed by the firm's stakeholders are more complex and challenging (Abdullah & Valentine, 2009). However, Virtue ethics theory focuses on moral excellence, goodness, and good character. Virtue is a state to act in a given situation. It involves two aspects, the affective and intellectual. Specifically, it suggests that doing the right thing with positive feeling and right reason (Abdullah & Valentine, 2009). Differently, Feminist ethics theory emphasizes on empathy, healthy social relationship, loving care for each other and the avoidance of harm. In an organization, to care for one another is a social concern and not merely a

profit centered motive (Abdullah & Valentine, 2009). On the other hand, discourse ethics theory (argumentation ethics) is concerned with peaceful settlement of conflicts (Abdullah & Valentine, 2009). There is also other ethical theory, Post modern ethics theory, which goes beyond the facial value of morality and addressed the inner feelings of a situation. It provides a more holistic approach in which firms may make goals achievement as their priority, foregoing or having a minimal focus on values, hence having a long term detrimental effect (Abdullah & Valentine, 2009).

Traditionally, without considering all of the above theories, corporate governance has been associated with larger companies and the existence of only agency problem (Dube, Dube, & Mishra, 2011). This is mainly due to the separation between ownership and control. Accordingly, it is tempting to believe that corporate governance would not apply to SMEs since the agency problems are less likely to exist (Dzigba, 2015). It is believed that an effective governance framework establishes stable and accepted relationships between an enterprise and other stakeholders (Lashgari, 2004). Furthermore, it is meant for a certain level of transparency towards stakeholders (Zhang & Thiam, 2014). Corporate governance structures can also be seen as frameworks to help organizations achieve long-term success for their stakeholders (ACCA, 2015). Corporate governance balances interest of firms with those of other stakeholders, including the firm's employees, customers, suppliers, as well as the community within which they operate. Some argue that because SMEs have few employees who are mostly relatives of the owner and, thus, no separation of ownership and control exists, there is no need for corporate governance in their operations (Afande, 2015). However, corporate governance requirement is a useful process that SMEs can adopt to improve their chances of sustained and successful longevity if all theories are considered. That's why many empirical studies suggest corporate governance norms for SMEs. According to CIPE, which is an affiliate of the U.S chamber of commerce, general principles of corporate governance with a view to improving sustainability and competitiveness of SMEs include fairness, transparency, dispute resolutions, and social responsibility. In line with this, argumentation ethics theory of corporate governance, discussed above, is concerned with peaceful settlement of conflicts, whether internal or external. Besides, fairness is implication of respect for and balances between the rights and interests of the enterprises' partners and stake holders including creditors, investors, government and others. Besides, transparency refers free flow and truthfulness of information: disclosure of financial as well as non financial information. This issue is concurrent with idea of feminist ethics theory in which more emphasis is given to healthy social relationship, loving care for each other and the avoidance of harm. This is for the reason that, to care for one another is a social concern, not merely a profit centered motive. Hence, SMEs are required to prepare financial statement. In view of this, there is financial reporting frame work for these entities (AICPA, 2013). SMEs stakeholders including finance providers like banks and other creditors, government agencies, suppliers/customers and employees need the raw material of finance function information distilled into actionable insights (ACCA, 2013). So, SMEs should keep complete accounting records and prepare financial statement (Amoako, Marfo, Gyabaah, & Gyamfi, 2014; IFRS, 2009). In addition, the presence of proper accounting and bookkeeping practices will increase confidence in the firm and make it less risky to invest or finance. Accordingly, SMEs that have information disclosure tend to have healthier growth rates and ratios of ordinary profits to that of capital, than firms that do not do so. Indeed, SMEs' financial statements including general balance sheet, income statement, cash flow statement, statement of changes in financial position and notes to the financial statements need to be disclosed. Moreover, it's advisable to disclose even non-financial information like information on the company's mission, vision and objectives; code of good corporate governance and others. Uchegara (2017) also supported this idea. In addition, stake holder theory discussed above is in favour of this idea. According to Develioglu & Hasit (2013); Dube, Dube, & Mishra (2011), corporate governance principles for SMEs include responsibility, accountability, transparency, and fairness. An effective system of SMEs governance should ensure compliance with applicable laws, rules, rights, and duties of all interested parties/stakeholders (Zhang & Thiam, 2014). Corporate governance hinges on a clear cut process of directing and controlling the whole essence of business based on the principles of integrity, conflict management, honesty, transparency and accountability in order to satisfy the interests of all stakeholders (Uchegara, 2017). According to ASX (2014), Safeguard integrity in financial reporting, make timely and balanced disclosure, recognize and manage risk are some of the principles of corporate governance. Promoting ethical and responsible decision making, safeguarding integrity of financial reporting; making timely and balanced disclosure, respecting the right of shareholders, and recognizing and managing risk are some of Principles of good corporate governance and good practice recommendations (CSA, 2007). As result, this practice can bring stability to markets, strengthen institutions, promote investment and weaken corruption. According to Terungwa (2012), risk management is also an integral part of good business governance. Thus, SMEs should know that risk management is so fundamental and it should be considered right from the start of the business to protect it from possible negative occurrences. According to COSO, internal control is one governance standard that is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations. Likewise, it is also important for SMEs as it affects their profitability. Hence, good internal

control structures are a prerequisite for good business. In the same vein, an effective internal audit function can help provide assurance that there are appropriate corporate governance processes in place. For the reason that, internal audit's primary responsibility is to ensure that risk management approach is being followed throughout the company, and that appropriate internal controls are in place and are operating effectively. In fact, internal audit function could be viewed as a "first line defense" against inadequate corporate governance and financial reporting (Guruswamy, 2012). Therefore, Strong, qualified and independent internal audit is an absolute must. Since it assists a business in accomplishing its objectives, by bringing a systemic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. In addition, Characteristics of good governance for SMEs include discipline, transparency, independence, accountability, responsibility, fairness, and corporate social responsibility (CPA, 2005; OECD, 2015; Barnes, 2013). As a principle of corporate governance, accountability is any disciplinary action in case of irregularities in financial statements. It is driven primarily by voluntary adoption of standards enforced by a basic framework of regulations. This is reinforced by the stakeholder theory approach where the organization is responsible towards all the individuals who come into contact in the course of its business. In view of this, introducing corporate governance in SMEs will improve the prospects of the SMEs in terms of access to finance (Htay & Salman, 2013). Organizations sometimes may not perform duties as desired by community (Tantalo, Caroli & Vanevenhoven, 2012). For instance, tax evasion and tax avoidances practices by business enterprises are considered as ignoring norms of corporate social responsibility (Yousaf, Jahangir, & Khalid, 2015). As long as tax is source of public revenue, it is obligatory for business to operate fairly and should be transparent in all financial matters as socially responsible to bring national happiness. SMEs should inspire confidence among the members of the local community and set goals serving the common good. Hence, meeting Social responsibility for customers, suppliers, creditors, government, competitors, employees, and community is vital to hold the balance between economic and social goals and between individual and communal goals. In a nutshell, it is appropriate for SMEs to apply corporate governance principles as long as corporate governance is one critical factor enabling SMEs development. Indeed, practicing good governance will help SMEs establish robust business processes.

## CONCLUSION

The popularity of corporate governance issue has generated much academic debate and research. Even though there are most debated issues of corporate governance for SMEs, the debates are not on the merits regarding need of corporate governance for the sector, rather on the appropriate governance norms for the sector. In view of this, the primary objective of the study was to review literature and suggest the applicable corporate governance principles for SMEs in general based on empirical studies and different theories of corporate governance. To do this, fundamental theories of corporate governance including stewardship theory, stakeholder theory, resource dependence theory, transaction cost theory, political theory, sociological theory and ethical theories of corporate governance including business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, and postmodern ethics theory are considered. In addition, prior empirical studies on corporate governance issues regarding SMEs were reviewed. From the review so far, it is possible to suggest suitable corporate governance principles that should be applied to SMEs. To this end, corporate social responsibility, risk management, compliance with rules and regulations, fairness and accountability, dispute resolution both internal and external, Transparency and full disclosure of information, Internal control, and Internal audit should be practiced by SMEs to bring new outlook and enhance competitiveness and stakeholder's value.

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