SME Governance: Converging Definitions And Expanding Expectations

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ABSTRACT

Recent events have focussed attention on corporate governance resulting in expectations for greater responsibility to shareholders and increasing obligations to an expanding group of stakeholders. Our research explores the application of the increased emphasis on corporate governance in the SME context including application of the converging definitions and expanding expectations and some specific challenges.

Keywords: small and medium enterprises, SMEs, corporate governance, stakeholders

INTRODUCTION

There has been increased attention on corporate governance and responsibility in recent years while at the same time there is additional emphasis on the importance of small and medium enterprises (SMEs) as drivers of economic growth in Canada, the United States (US) and the European Union (EU). This provides a compelling background to explore corporate governance issues impacting SMEs. The negative consequences of illegal and unethical corporate practices have provided impetus to re-examine the changing roles, responsibilities and public expectations for corporate governance. While recent attention has occurred most frequently in the large business environment, the impact on the changing roles of board members for organizations of all kinds should not be overlooked (Teksten, Moser & Elbert, 2005). This article explores corporate governance in SMEs commencing with an overview of the background to corporate governance and its expanding expectations.

BACKGROUND CORPORATE PHILOSOPHIES

Historical business philosophy has influenced the role of corporate governance. There are two predominant governance models in the business world: the shareholder wealth maximization model (also known as the shareholder value maximization model) and the stakeholder capitalism model (also known as stakeholder value maximization model). The shareholder wealth maximization (SWM) model is mainly practiced in the Anglo-American markets such as the United Kingdom, the US and Canada hence it has also frequently been labelled as the Anglo-American model. The stakeholder capitalism (SCM) model is mainly practiced in continental Europe as well as Japan hence it has also been called the continental European model, the European Social model, or the non-Anglo-American model. In addition to different practicing countries, the two models differ in other aspects. Table 1 presents a comparison of the two models.

The underlying assumptions about share price efficiency and systematic/unsystematic risk in the SWM model are drawn from the traditional finance theory, which has been under serious criticism in recent years. These assumptions are the theoretical foundation of the SWM model and the view that the firm's single and exclusive objective is to maximize shareholders' wealth.

Under the SWM model, management is often preoccupied with the task of how to meet the analysts' quarterly earning expectations which are key determinants of the movement of the firm's share price in the short term. Thus short-term profitability is more dominant than the firm's long-term growth as a management objective. External pressure for super performance and internal drive for astronomic compensations can eventually lead to unethical and unlawful conduct. From Enron's collapse in 2001 to the recent financial crisis which originated on Wall Street, the tragic consequences of bad corporate governance are in evidence. A number of top corporate executives have been prosecuted and convicted for their criminal conduct. In some sense, these executives are also the victims of the so- called "impatient capital" which characterizes the SWM model.

Table 1: Comparison of Shareholder Wealth Maximization and Stakeholder Capitalism Models

Shareholder Wealth Maximization Model	Stakeholder Capitalism Model
Based on the assumption of share price efficiency i.e. the share price in the market reflects intrinsic value and shareholders' wealth	No assumption on share price efficiency
Firm's objective is to maximize shareholders' wealth by achieving the highest possible total return to equity (including both capital appreciation and dividend distribution)	Firm's objective is to maximize corporate wealth but return to equity is constrained by the interest of other stakeholders such as creditors, employees, governments, etc.
Only systematic risk is a prime concern for management as unsystematic risk is supposed to be diversified	Total risk (operating and financial risk) is considered by management
Corporate strategies are directed by the board on behalf of shareholders	Corporate strategies are influenced by long-term stakeholders rather than mobile portfolio investors

On the other hand, the multiple objectives of the SCM model are difficult to measure and evaluate. The SCM model has come under increasing criticism for its lack of accountability to the firm's owners - its shareholders, because it tries to meet the demands of a diffuse a group of stakeholders (Moffett, Stonehill & Eitman, 2003). Another issue with the SCM model is that the exclusion of the strong focus on the interests of mobile portfolio investors in corporate governance may hinder the inflow of much needed capital, particularly international capital.

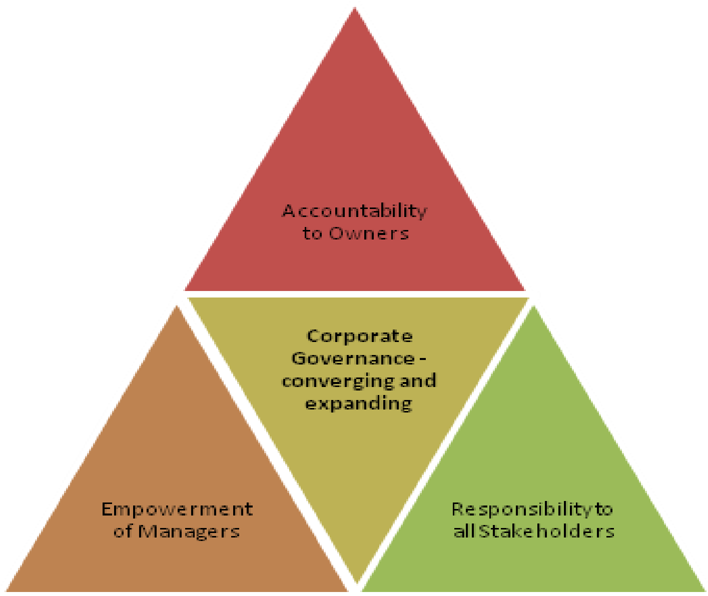
CONVERGENCE AND EXPANSION

Progress in pursuit of a better governance model has already gone beyond pure academic discussions. The Organization for Economic Cooperation and Development (OECD) has issued a widely accepted set of principles for good corporate governance practices, covering the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board (OECD, 2004). This is an important milestone in corporate governance since some OECD member countries subscribed to the SWM model and others to the SCM model. The OECD principles have established a common ground for the two camps combining the strengths and overcoming the shortcomings of both models and ensuring that the corporate goal has a long-term orientation, but at the same time the firm is accountable to a range of stakeholders and performance is measurable for investors.

The pressure to strengthen corporate governance is also increasing across Europe. "An atmosphere of litigation applying to companies falling short of accepted standards has also been growing …., with individual shareholders and classes of shareholders taking legal action against directors perceived to act in their own interest rather than on behalf of the company" (Plath & Wilde, 2005). Recent events and the related emphasis on the role of corporate governance have now included ultimate responsibility to shareholders which is emphasised in the SWM model along with a level of responsibility to the interests of a wider group of stakeholders that has always been the distinguishing feature of the SCM model.

In addition to the trend of convergence, the expectations on corporate governance are also expanding. One such area is that of management empowerment. At the same time that increased accountability is being implemented, management needs, more than ever, to be empowered in order to act entrepreneurially (Coulson-Thomas, 2007). This empowerment is essential to maximize opportunities available to the firm. The incorporation of management control and management motivation into corporate governance presents a real challenge and adds a further complexity. We use Figure 1 to depict corporate governance with the combination of an obligation to a broader range of stakeholders and a responsibility to empower management in addition to accountability to owners, as discussed in this section.

Figure 1: Convergence and Expansion of the Definition of Corporate Governance



As a result of the emerging situation discussed in this section, corporate governance now includes increased fiduciary responsibility to shareholders, responsibility to an expanded group of stakeholders for their interests in the firm, and the ability to both control and motivate management. The next section considers the application of this expanded and expanding definition in relation to SMEs.

GOVERNANCE IN THE SME CONTEXT

The defining of corporate governance originated in the large business environment and its application and relevance to SMEs is largely unexplored (Coulson-Thomas, 2007) yet SMEs are expected to be the drivers of economic growth and providers of employment and investment opportunities in many nations, including Canada, the US and Europe and Australia (Banham, 2005; Wiesner, Macdonald & Banham, 2007 and Zahra, Neubaum & Naldi, 2007).

While organizational size and the overlap of management and ownership add complexity to governance in the SME context, this combination has always ensured that responsibility to owners exists to the highest possible degree. In addition, since SMEs are largely unfettered in their decision making role – the owner/manager is free to act entrepreneurially which is considered essential in the rapidly changing business environment of today. However without input from an effective and well structured board SMEs may not always see strategic opportunities (Brunninge, Nordqvist & Wiklund, 2007). The capacity for entrepreneurial action is an advantage that SMEs do not want to sacrifice to improved governance (Coulson-Thomas, 2006) and especially since governance in larger organizations is challenged by the need to add capacity to innovate to their managers. SMEs already enjoy the motivational aspect that large businesses are trying to emulate.

The aspects of governance described as accountability to owners and empowerment of managers are actually embedded in the organizational structure of many SMEs, particularly those where there is private ownership and the owner is very involved in the day to day operations. Conversely the responsibility to the broader range of stakeholders can become a challenge to SMEs as owner/managers/directors are very involved in their organizational activities. Consideration of the interests of employees, clients and suppliers, as well as the broader community when making business decisions has not always been the situation in SMEs. Consequently, the potential benefits to strategic direction and growth have not always been realized.

The following table summarizes the SME situation in relation to the aspects of accountability to owners, responsibility to stakeholders and the empowerment of managers.

Table 2 Corporate Governance relative to Business Context

Corporate Governance	Big Business Context	SME Context
Accountability to Owners	Primarily inherent by regulation	Embedded
Responsibility to Stakeholders	Expanded group of stakeholders to be considered, Not always regulated	Expanded group of stakeholders to be considered Not usually regulated
Empowerment of Managers	Needs improvement in current global environment	Embedded

The table highlights the embedded nature of accountability to owners and empowerment of managers that exist in the SME situation. It is also clear from the above comparisons that more attention should be paid to responsibility to stakeholders in the SME situation. This indicates that the largest portion of new resources and attention allocated to corporate governance in SMEs should be directed to the area of responsibility to stakeholders (creditors, employees, etc.). As shown in Table 2, none of the three converging and expanding areas of governance are embedded in large corporations. Therefore all three factors require significant attention and resource allocation in the large business environment in order to implement an improved governance model and meet the converging and growing expectations. The embedded nature of management empowerment and accountability to owners are distinctive features of SME governance compared to large corporations. This analysis has important implications for resource allocation in the area of corporate governance.

This analysis is consistent with differences in management behaviour between large businesses and SMEs. Decisions in relation to financing the firm are considered to demonstrate this situation.

The importance of capital to SMEs is well documented. While SMEs may seek equity financing, public offerings are not common for most SMEs. Such firms rely to a large extent on equity financing obtained from founders/owners, employees, relatives and friends, retained earnings, and venture capitalists and companies. This is mainly due to requirements for listed companies which most SMEs are unable to meet. However many SMEs do seek debt financing. Unlike large businesses, SMEs largely rely on trade credit, loans from employees, friends and relatives, other private loans, and government lending agencies. Furthermore, the debt in SMEs is more likely to be short-term oriented than is the case with larger businesses. On one hand, the tendency to debt financing is partially due to its advantage relating to ownership control; on the other hand, the short-term nature of readily available debt financing has disadvantages such as the lack of predictable continuous resources and backup finance.

SMEs are apparently in a disadvantageous position compared to large corporations when it comes to financing, particularly in dealing with lending institutions. Using data from a survey of 91 banks in 45 countries, Beck, Demirgüç-Kunt and Pería of the World Bank (2008) find that banks perceive the SME segment to be fraught with macroeconomic instability in developing countries and high levels of competition in developed countries. These factors are viewed as the major obstacles in lending to SMEs. In both developing and developed economies overall banks are less engaged with SMEs and charge such firms higher interest rates and fees than they do larger organizations because of the higher levels of risk and higher numbers of non-performing borrowers.

How to overcome this disadvantage is not only a managerial issue but also a governance issue. Lending institutions are essential to the survival of the business for SMEs and financial institutions are a very important stakeholder in the expanding definition of governance. Therefore consideration of the relationship with the banking sector should be a focal aspect for SMEs from the viewpoint of governance.

Application of the broader definition of corporate governance in the SME environment particularly in relationship to responsibility to a broader range of stakeholders has much to offer to the viability and growth of SMEs. The specific example of an improved relationship with the providers of finance has the potential to improve the situation for both the SMEs and the lending organizations.

Some governance challenges relative to SMEs are discussed in the conclusions and recommendations in the next section.

CONCLUSIONS AND RECOMMENDATIONS

Stakeholders expect corporate governance to provide wealth maximization for shareholders, to fulfil obligations to a broader range of stakeholders including employees, customers, suppliers and community, and to provide management control as well as management empowerment. The expectations for responsibility to shareholders and for management empowerment are effectively embedded in SMEs. However SMEs are facing a significant challenge in relation to incorporation of responsibility to an expanded group of stakeholders. While SMEs have emerged as a dominant economic force, there are significant unrealized potential benefits available by successfully addressing this specific aspect of corporate governance and its implementation.

One of the major characteristics of modern corporations is the separation of ownership and management. However, unlike large corporations, most SMEs have kept the close ownership-management relationship as an inherent tradition. The combined ownership-management function has a positive side in relation to governance in SMEs, that is, accountability to owners and empowerment of managers are embedded in the organizational structure. The result is that governance is more efficient in SMEs as it is without the "agency problem" that exists in larger organizations. SMEs would be well advised to direct more attention and resources to fulfil the responsibilities to, and improve relationships with, stakeholders.

The negative side of the combined ownership-management function is that SMEs may not wish to have formal boards of governors or may not wish to bring in outside directors to their boards as they want to maintain tight ownership control. However, in today's competitive business environment, this attitude may set barriers to generating new ideas, developing better strategies and taking more innovative approaches; in the worst scenario, it may ultimately threat the very survival of the business due to the loss of its competitiveness.

This presents a very real challenge. How can SMEs take real advantage of the benefits arising from the inherent organizational structure in corporate governance and at the same time enhance the board formation to embrace constantly changing business environment? It is not only a matter of how to balance the above-mentioned positive and negative effects but also an experiment on how to advance SME governance to a new level with greater commitment to a wider range of stakeholders.

Additional research is warranted in the composition of SME governance structures. While research has demonstrated increased capacity for strategic change by having outside directors and a larger board, SME owners are concerned about losing the flexibility which is one of their greatest strengths. Dissemination of the operational benefits of sound governance to SMEs in relation to increased capacity to engage in new business and to implement strategic change is at less than optimum levels. It is therefore recommended that educators, consultants and service organizations would be well advised to take on this challenge.

AUTHOR INFORMATION

Dr. Heather Banham earned her DBA at the University of Southern Queensland, Australia and holds her professional accounting designation as a CGA (Certified General Accountant) in Canada. She is currently involved in "Building Small Business Human Resources", a British Columbia provincial government initiative from the Ministry of Small Business and Revenue.

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