Think Ahead ACCA

Governance for all: the implementation challenge for SMEs

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Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills required by employers. We work through a network of 92 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

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Global Forum for SMEs
The Forum provides a unique platform for promoting the role of SMEs in the global economy. Representing over 15 countries and a wide range of professional backgrounds – from finance institutions, academics and professional advisers to entrepreneurs themselves – the Forum represents the sector's needs at a global level and facilitates the sharing of best practice.

This report aims to encourage understanding of what corporate governance means for SMEs.

It draws extensively on material presented and discussed during a seminar organised by the Economic and Social Research Council (ESRC) and held in ACCA's London offices on 19 November 2014 and incorporates the views of the ACCA Global Forum for SMEs.

1. Introduction

Corporate governance is now seen as an essential building block of stable economies.

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The challenge for SMEs is that established corporate governance frameworks have been developed with large, listed companies primarily in mind. Such frameworks and codes may not reflect the characteristics of the SME, where owners may often be its managers as well, or where company ownership may be shared across family members.

This report aims to encourage understanding of what corporate governance means for SMEs. It draws extensively on material presented and discussed during a seminar organised by the Economic and Social Research Council (ESRC) and held in ACCA's London offices on 19 November 2014.

Unless other specific references are provided, content is drawn from these presentations. The event focused attention on the role of appropriate governance frameworks for encouraging socially responsible behaviour and commercial success among SMEs. Speakers included academics, professional advisers and representatives of international institutions. This report also incorporates the views of the ACCA Global Forum for SMEs, and the discussions that took place there in March 2015.

THE ESRC SEMINAR ON 'GOVERNANCE, CSR AND SMES IN EMERGING ECONOMIES' ON 19 NOVEMBER 2014

Presentations from the seminar, can be found at: http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2014/november/emerging-economies.html

Speakers at the seminar were:

- Jeremy Moon, Velux Professor of Corporate Sustainability at the Centre for Corporate Social Responsibility, Copenhagen Business School
- George Frynas, Professor of Strategic Management and CSR, Middlesex University, London
- Tracy Gordon, one of the leaders of Deloitte's UK Centre for Corporate Governance
- Kiril Nejkov, Operations Officer, Corporate Governance, International Finance Corporation
- Laura Spence, Professor of Business Ethics and Director of the Centre for Research into Sustainability at Royal Holloway, University of London
- Mike Wright, Professor of Entrepreneurship and head of the Innovation and Entrepreneurship Group at Imperial College Business School, London.

2. Why corporate governance matters to SMEs

Corporate governance structures can be seen as frameworks to help organisations achieve long-term success for their stakeholders.

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The Organisation for Economic Co-operation and Development (OECD) describes corporate governance as follows: 'Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring' (OECD 2004).

Given that all companies want to attain their objectives, corporate governance is relevant to organisations of all sizes. Nonetheless, the aims and nature of the corporate governance framework applied are likely to vary from one company to another.

Corporate governance in large businesses is associated with the agent-principal issue: managers are agents for the shareholders (the principals and owners). Corporate governance involves trying to establish a framework, systems and controls that encourage management to act in the best interests of the shareholders. It is also increasingly seen as needing to take account of the interests of other stakeholders, such as employees and suppliers, and wider societal issues such as appropriate stewardship of environmental assets.

In family-owned businesses and SMEs in general, the agent-principal issue is less likely to arise, or less likely to be so significant. Where the owners are also the managers, management and ownership interests are aligned, but these interests are not necessarily those of other stakeholders. For instance, where there are family shareholders who are not actively involved in running the business, some mechanisms may be required to protect their interests.

In general, however, for SMEs, corporate governance is mainly about improving business efficiency and performance, and less about monitoring the actions of management.

ELEMENTS OF GOOD CORPORATE GOVERNANCE

The corporate governance framework applied to any business has to be fit for purpose, which includes being appropriate for the size and maturity of the business. In general, a robust and effective corporate governance framework includes a number of features and characteristics.

- There should be clear reporting lines and clarity about how decisions are made and risks controlled, and about other matters that need to be brought to the board's attention (or the attention of committees) for review or approval.
- The framework should promote understanding of roles and responsibilities and limits of authority and set the balance the board wants to see between, for example, acceptable risk and reward.
- Any incentives for staff need to be supportive of board strategies.
- There needs to be clear communication (of strategic goals, expected behaviour, etc) by the board to management and staff.
- Appropriate internal controls should be established, related to key risks.
- Boards need to have good visibility of management actions and decision making, which includes the provision of high-quality information on business performance and risk management.

Board structures may differ among family-owned SMEs. There may not, for example, be a unitary board. Some firms may have a (formal or informal) dual board arrangement, with an operations board and a separate advisory board addressing more strategic issues or representing wider family interests.

WHAT DOES GOOD CORPORATE GOVERNANCE LOOK LIKE FOR SMES?

There is no universally approved standard model of corporate governance for SMEs. Nevertheless, there are sources of guidance to which SMEs and their advisers can turn.

The European Confederation of Directors Associations (ecoDa) has issued *Corporate Governance Guidance and Principles for Unlisted Companies in Europe*, designed to be a practical tool for businesses and their stakeholders (ecoDa 2010). Though developed with European companies in mind, the guidance and principles also have relevance to businesses in other regions. As ecoDa (2010) notes, good corporate governance for unlisted companies is about 'establishing a framework of company processes and attitudes that add value to the business, help build its reputation and ensure its long-term continuity and success'. It presents 14 principles of good governance that are based on a 'dynamic phased approach, which takes into account the degree of openness, size, complexity and level of maturity of individual enterprises'.

In the UK, the Quoted Companies Alliance (QCA) has developed a code with smaller listed companies in mind, *Corporate Governance Code for Small and Mid-Size Companies* (QCA 2013). The UK's Institute of Directors has also offered guidance in the form of *Corporate Governance Guidance and Principles for Unlisted Companies in the UK* (IoD 2010). The British Standards Institute has published a standard on governance designed to be applicable by any type and size of entity, its *Code of Practice for Delivering Effective Governance of Organizations*' (BSI13500:2013) (BSI 2013). Elsewhere in the world similar efforts have been made, such as *The Corporate Governance Code For Small and Medium Enterprises: Building the Foundations for Growth and Sustainability in Dubai* (SME Dubai and Hawkamah) and *Guidelines on Corporate Governance for SMEs in Hong Kong* (Hong Kong Institute of Directors 2014).

The International Finance Corporation (IFC), the largest global development institution focusing exclusively on the private sector in developing countries, has issued its own IFC *Family Business Governance Handbook* (IFC 2011). As its title indicates, the handbook is specifically designed for family-owned businesses – many of which will be SMEs – and takes account of their particular characteristics. The issues it considers include:

- the roles often played by family members in a business
- the necessity of developing a clear family governance structure as different generations join the business
- the role, structure and composition of the board of directors (including the role of independent directors), and
- the impact of senior managers on the business and the importance of developing a CEO succession plan.

The IFC has also developed a Corporate Governance Progression Matrix, which sets minimum requirements for four levels of corporate governance, from basic to best practices. These requirements cover a number of categories of corporate governance:

- commitment to sound corporate governance
- structure and functioning of the board of directors
- control environment and processes
- transparency and disclosure
- rights of minority shareholders.

The matrix can be used to assess the maturity of corporate governance in individual businesses.

HOW SMES BENEFIT FROM APPROPRIATE CORPORATE GOVERNANCE

SMEs can gain a range of benefits from establishing appropriate corporate governance in their businesses. These include:

- less risk of conflict between family members or other owners who are actively managing the business and those who are not
- enhanced access to credit
- faster business growth
- greater resilience to fraud, theft or other financial costs due to poor internal controls.

The IFC works with SMEs to help them improve their corporate governance. Six-monthly surveys conducted during the two-year period after the IFC's involvement typically find that the changes SMEs make are those likely to improve performance. For example, they often include the establishment of clearer roles and responsibilities, the strengthening of control systems and succession planning activity. These findings come alongside more easily quantifiable data, such as additional finance raised by the company.

3. The value and impact of boards

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Bringing in external independent directors (including non-executive directors – NEDs) gives the SME access to a broader range of skills, experience and personal characteristics. It can also help the SME tap into a wider network of contacts. As ecoDa has noted when setting out its corporate governance principles for unlisted companies: 'A key step in the development of unlisted company governance is the decision to invite external directors onto the board. Its effect on boardroom behaviour and culture should not be underestimated' (ecoDa 2010).

New directors who complement the owners' expertise are particularly valuable. For example, in SMEs formed as spin-offs from university research projects, external directors generally bring commercial contacts and insight to complement the founder's academic and technical expertise.

Anne Kimari, a member of ACCA's Global Forum for SMEs, says: 'Non-executive directors bring a fresh look to the business. They see things that business people do not see and assist in giving perspectives from the customer/supplier or regulator's point of view.'

Rhonda Best, also a member of ACCA's Global Forum for SMEs, notes: 'NEDs provide objective criticism and judgement on issues of strategy, performance and processes'.

GROWTH PATTERNS

Research has indicated some linkage between board composition and SME growth prospects. Companies experience less growth when they have high turnover among board members, and when their board members have past experience of failure or of only limited success.

The way that a business grows may also be affected by its board. For example, businesses with outside directors on the board are more likely to grow by acquisition rather than organically. This may be because the external directors have contacts they can draw on when seeking to make appropriate acquisitions and/or because they have a greater understanding of the wider business environment and better market information.

ACCA's Anne Kimari believes that SMEs can particularly benefit from strong corporate governance and the input of NEDs during times of growth or at crisis points. She says: 'Key stages would be when there is rapid growth and expansion and where the founders are out of scope with how to manage the growth phase. They have been relying on a certain way of funding, for example, and find that it can no longer work. They need assistance to keep up with the growth or else they will find it very difficult to succeed. Corporate governance is also valuable in times of crisis when there is a need to have fresh ideas or a fresh way of handling different challenges that are arising. Having a sounding board would provide huge assistance or benefit to the institution.'

STRONGER CONTROLS

A properly functioning board can help to ensure that performance and management conduct are both monitored properly in SMEs. As noted by Professor Andrew Chambers, one aspect of this is oversight of the scale of management's drawings, which can threaten the survival of an SME: 'There is also an enhanced risk that poor quality of management information makes it harder to determine whether the SME is drifting towards insolvency than in a large company with specialist management accountants serving the board well...a properly functioning board can be instrumental in ensuring that the SME's management information is of sufficient quality to be a suitable basis for exercising effective oversight'.

BOARDS AND BUSINESS FAILURE

UK research has found that the characteristics of the board in family-owned firms influence the likelihood of business failure. Lower failure rates were found to be associated with boards that have more experienced members, greater gender diversity and members with multiple directorships. Having female board members, for example, may have an impact on risk-taking behaviour, or may influence the leadership style in the business. Individuals with multiple directorships may have a wider contact pool to call on, whether as trading partners or providers of financial support.

Increased turnover of board members was also found by the research to be linked to higher risk of failure. This may reflect a lower level of director commitment or competence. Similarly, where board members had past experience of business failure, the risk of insolvency increased slightly.

In general, therefore, although creating a board and bringing in external directors can be beneficial for family businesses and SMEs in general, it is important to consider what particular skills and experience the individuals contribute.

SME LIFECYCLE AND BOARD EVOLUTION

Most businesses do not exist in a static state, but are constantly evolving. For this reason, the role of the board also needs to evolve over time. As the firm matures, the greater the need to bring in outside directors. Those external board members may initially be most valued for their complementary, additional skills and their network of contacts. Later their role may focus more on managing the potential for conflicts between core and extended family interests during succession management.

When representatives of private equity (PE) and venture capital (VC) firms join SME boards, they tend to fulfil both a monitoring and a value-adding role. They may bring expertise that fills a skills gap on the board. Third-party independent directors – with no affiliation to management or the PE/VC firm – may also be introduced. They can play an important role not only in providing expertise, but also in helping to avoid conflict between the entrepreneur and the investors.

4. Corporate governance triggers and challenges

One of the biggest triggers for corporate governance change in an SME is the emergence of a younger generation in the business.

One of the biggest triggers for corporate governance change in an SME is the emergence of a younger generation in the business. This encourages thinking about the changing role of the founder, who may come to focus more on strategic decision making and leave day-to-day operations to other family members or managers brought in from outside.

Another important trigger is the need for external finance, whether from a bank, other lending institution or a private equity provider, or obtained through a stock market listing. Where this need results in the recruitment of independent NEDs with experience in or understanding of financial institutions, substantial change can be achieved fast. Introducing champions of corporate governance who understand its importance and benefits can make a real difference to overcoming internal barriers from family owners.

Many other triggers exist, resulting from the changes in the trading environment, such as the impact of globalisation, or from the need to make large investments, such as in ICT systems and data management.

OBSTACLES TO CHANGE

Even where a trigger for change occurs, potential obstacles can arise that prevent corporate governance measures from being adopted or that impede their effectiveness. These include:

- a lack of understanding of how company boards and independent NEDs are supposed to work
- difficulty in finding high-quality NEDs (though this may sometimes be an excuse for failure to make appointments)
- a desire for guarantees (which cannot be made) that the SME will benefit from cost savings as a result of raising corporate governance standards in the business, for example, by appointing NEDs
- failure to see the urgency of improving governance when compared with other pressing business issues, such as managing cash flow.

Advisers working with SMEs need to challenge these perceptions, which are often the reasons for inaction.

Ken Lee, a member of ACCA's global forum for SMEs, sees three key barriers to the greater adoption of good governance by SMEs: 'There is a lack of people with good governance expertise. SMEs also generally have a limited budget for engaging good consultants to support them and advise on good governance. And finally, they may just lack awareness of [the importance of] good governance.'

GENERAL CHALLENGES TO INTRODUCING CORPORATE GOVERNANCE IN SMES

There are a number of general challenges to encouraging improved corporate governance among SMEs and family-owned businesses:

- difficulties in interpreting an expression of need
- lack of awareness of need
- lack of standardisation
- problems with understanding the changes needed
- cost concerns.

DIFFICULTIES IN INTERPRETING AN EXPRESSION OF NEED

Family-owned SMEs may identify some issue in the business that needs to be addressed to improve performance and prospects. For example, following a period of business growth, internal decision-making structures may need to be strengthened or formalised. The solution may lie in some form of corporate governance improvement – but SMEs may not necessarily frame their need in such terms. They may need external advisers or institutions to make the link with corporate governance structures and advise them on appropriate solutions.

LACK OF AWARENESS OF NEED

Corporate governance codes have generally been formed with large or listed companies in mind. This has created a challenge for advocates of corporate governance among SMEs and private businesses. These smaller businesses, and even market regulators, may assume that corporate governance has no relevance for them.

LACK OF STANDARDISATION

Another challenge is that what is appropriate for a large or listed company may be less relevant or appropriate for an SME, family-owned business. There is in fact a lack of standardisation of the components of 'good' corporate governance for SMEs.

The IFC has developed its own methodology for evaluating corporate governance risks and opportunities. This has been distilled into the Corporate Governance Development Framework, a common approach now adopted by over 30 development finance institutions (DFIs) around the world for use in their investment processes. Such DFIs include the European Bank for Reconstruction and Development, the Asian Development Bank and the Islamic Development Bank. They have taken the IFC corporate governance methodology as a set of standards to use when assessing corporate governance risk before investing in a business. A DFI Toolkit on Corporate Governance (DFI 2010) is available to participating DFIs, including a Corporate Governance Questionnaire (IFC n.d.) to help with the assessment of current corporate governance standards in a business, and a Corporate Governance Progression Matrix (see Chapter 2).

PROBLEMS WITH UNDERSTANDING THE CHANGES NEEDED

When SMEs ask for help with implementing or improving corporate governance, they may not fully understand the impact of the changes they need to make. Instituting effective corporate governance may involve bringing outsiders into the business, as independent NEDs, for example. Family insiders and business founders can find this quite challenging – it is potentially a greater adjustment to the business than bringing in external management expertise.

COST CONCERNS

Some SMEs may be hesitant about introducing independent non-executive directors because of concerns about the cost of remunerating them. This could, however, be addressed by linking their reward with the performance of the company through the granting of an equity stake. 'The reluctance of SME management and shareholders to pay non-executive director fees is understandable as finance is usually tight. Payment of these fees out of retained earnings is risky and large sales need to be made in order to generate the funds to pay non-executive director fees. Alternative ways of rewarding SME NEDs are by awarding shares or share options' (Chambers). One challenge with remuneration through shares is that there may be no market price for the shares. As Professor Chambers notes, 'Rewarding SME NEDs in shares or share options is more straightforward if the SME has an exit strategy which, if it is achieved, will realise the value in the shares.'

HOW TO SUPPORT CORPORATE GOVERNANCE CHANGE IN SMES

When it comes to advising SMEs on corporate governance, there is no one-size-fits-all solution. SMEs are highly diverse, and this diversity needs to be taken into account.

Training is often appropriate, and more intensive in-house support may be required than when working with larger entities. It may not be sufficient simply to propose the changes to structures or processes needed to improve corporate governance standards. The changes need to be explained in some detail to owners and managers within SMEs, as well as their implications for the business and the benefits that implementing them should bring.

Advisers and international institutions need to continue making the case for why corporate governance matters to SMEs. This is vital for creating a receptive environment and overcoming barriers to action.

Case study

This type of situation has arisen in the IFC's work with SMEs. For example, the IFC worked with and invested in a family-owned business in the Kyrgyz Republic which originally specialised in packaging for the food sector. The business was founded by three family members, although one was the real powerhouse behind its growth and development. As the business grew it expanded operations into Uzbekistan and began moving into the construction sector. The owners sensed they needed to improve their management and decision-making tools. When the IFC reviewed the business, it identified 'key-man' risk as the biggest issue, because of the dominant role played by one particular family member. It therefore raised the need for succession planning, whether within the family or from outside it. It also advised on how to set up a coherent framework of internal controls appropriate for the business. The IFC therefore translated the needs of the family and the business into a corporate governance solution.

5. Conclusion

There are many challenges to understanding the role that corporate governance can play in helping SMEs to grow.

There are many challenges to understanding the role that corporate governance can play in helping SMEs to grow. More research needs to be undertaken to understand the impact of corporate governance on SMEs and the various barriers that stand in the way of greater implementation of effective corporate governance.

Challenges also arise in encouraging the owners of SMEs to take the time to understand what corporate governance means and how improving it could benefit the business. The basic terminology also needs to be taken into account: SMEs that are unincorporated or family-owned may see the word 'corporate' and assume that a corporate governance framework has no relevance for them.

The fact that corporate governance frameworks and approaches were typically developed for large businesses can also be a barrier to their adoption by SMEs. Frameworks need to be applied flexibly, taking account of the heterogeneous nature of SMEs.

It is also worth emphasising that corporate governance frameworks and their effectiveness are influenced by the environment in which they exist. In an economy characterised by widespread corruption or weak enforcement of laws and regulations, company action to implement corporate governance standards may be frustrated and have limited impact. Such constraints need to be understood by businesses and institutions in better-regulated economies.

International organisations, including the IFC and ACCA, can have an impact through supporting research and understanding of the challenges and benefits of achieving improved standards and greater corporate governance adoption in SMEs. They can also play a role in raising awareness and understanding – building capacity and expertise among local businesses and their professional advisers.

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