Governance of New Zealand SMEs: Insights from the agricultural sector

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ABSTRACT *This paper presents the results of a study of the governance of SMEs. In 2010 some 700 owners, 450 businesses, attended one of 18 day-long workshops sponsored by their rural financier. The aim of the workshops was to enhance knowledge and understanding of governance, management, and leadership. The workshops provided a unique opportunity to gather data on governance attributes from first party sources. Results were captured through written surveys, as well as verbal and physical acknowledgement to specific questions. Businesses were largely deficient of the attributes of mature (best practise) governance, dominant attributes resembling those of a founder-led enterprise. Seldom was the distinction between shareholders, directors, managers or even labour upheld. The likelihood and cause for lost opportunities is discussed.*

Keywords: Board composition, board independence, board roles, convergence, shareholders, stewardship

INTRODUCTION

Over the last two decades the data for much reputable governance research has been provided by third party listings reporting the attributes of publicly listed companies, such as, Compustat (Monroe 2006). The perspective through which the majority of that governance research has subsequently been undertaken is agency theory (Daily, Dalton & Rajagopalan 2003). The reasons for, and limitations of this narrow approach to governance research, can partly be explained by Bennis and O'Toole's (2005) phenomena *physics envy*. This is, in turn, fuelled by the availability of such large data sets; the increasing ease at which econometric analysis can be conducted; and, the ongoing preference towards quantitative analysis to enhance academic career progression (Bennis & O'Toole). Using multivariate analytical techniques (Judge et al., 1988) the process and outcome of governance and its subsequent contribution to business performance is reduced to a relatively simple input-output model (Lockhart 2010). This dominant approach to understanding governance is further limited by both the lack of theory linking antecedent and outcome variables – other than agency (Jensen & Meckling 1976), as well as the failure to produce a systemic understanding of the impact of various attributes, including those within the boardroom itself – the *black box* (Leblanc & Gillies 2004; Lockhart 2006). In short, the research community has yet to establish causality between governance and subsequent performance (Huse, Hoskisson, Zattoni & Vigano 2011; Pugliese et al. 2009).

In many economies family owned small to medium-sized enterprises (SMEs) make a disproportionate contribution to national wealth (Astrachan & Shanker 2003). Because individual family members hold multiple roles neither the features nor the requirements of their governance are particularly well understood (Tagiuri & Davis 1996). A positivist body of knowledge on governance functionality is emerging from Europe recognising that family firm governance 'violates almost all of the underlying assumptions of traditional governance theories' (Mustakallio, Autio & Zahra 2002: 205). In contrast to (Swinnen et al. 2010) these businesses increasingly appear to be in need of more formal governance as suggested by Mustakallio et al. At the very least this need is motivated by external reporting to debt financiers (motivation for the workshops) and third party equity providers (continuous disclosure). Nor do large data sets exist that may assist research of the antecedent variables used in governance input-output modelling for SMEs. Publicly available company registrations in various jurisdictions seldom aggregate statistics (see the New Zealand Companies Office 2011). Therefore, analysis of antecedent governance variables can only occur with substantial investment in a priori coding, such as, that undertaken by Mustakallio et al. In the absence of having intimate knowledge of each company, only achieved through case studies (Yin 1988a, 1993b), for example, those published by Steier (2001), and Lockhart and Taitoko (2005) the identification of director attributes and other structural characteristics of the firm's governance is a near impossible task. However, the entire discussion of SME governance is underpinned by the assumption that the company (Micklethwaite & Woolridge 2003) is the preferred vehicle for growth not the entrepreneur (Haynes, et. al. 1999; Gabrielsson 2007; Granovetter 1985) in which case 'governance' may be of little consequence to anyone other than the external providers of capital.

The aim of this paper is to present the results of a year-long study of the governance of SMEs in New Zealand's export-dependent agricultural industry and to report on current trends and common behaviours observed in these rural businesses. This opportunity was created through unique access provided by an executive education contract between the author's parent institution and the country's largest rural financier.

Ethical approval was sought for this research. The project was evaluated by peer review and judged to be low risk.

LITERATURE REVIEW

Business schools and business researchers (Podolony 2009) seldom venture behind the farm gate. In most developed nations the responsibility for the business education of farmers and the research of their enterprises lies mostly beyond the interests of b-schools. The University of Auckland's Icehouse Agribusiness Programme is the one exception in New Zealand (The Icehouse 2011). The generic domain of b-schools starts largely at the first stage processor (Davis & Goldberg 1957), and may encompass some of the attributes of supply chain management but that too is mostly downstream of producers. Despite that neglect emerging concerns of governance (Cadbury 2000), leadership and management (Bates 2011), especially those relating to small business (in terms of employee numbers), ought to be transportable across sectors. Therefore, b-school knowledge should be of relevance to this community providing a thorough understanding of the context is sought, and the knowledge is then appropriately applied. The warning here is that much of what is written in the domains of corporate governance (OECD 2009; Pieper 2003), leadership, and management is likely to be of little immediate relevance to rural family businesses. The same argument could be said to apply to small family businesses elsewhere, especially when legal responsibilities are relatively trivial (Davis 2007). This in part may explain the justification for the development of an increasingly independent body of knowledge (Lansberg, Perrow & Rogolsky 1988) concerning family firms (e.g., Carlock & Ward 2001; Ward 2004; Casper, Dias & Elstrodt, 2010).

Until the late 1990s the source of much business success was attributed (or otherwise) to the CEO (Peters & Waterman 1982). In many nations, especially the United States of America, the CEO was, and to some extent still is, heralded as the corporate saviour (Iaccoca 1988: Khurana 2002) and has reached demi-god status. Much of this literature has attracted considerable criticism (Jackson 2001; Micklethwait & Wooldridge 2003; Rosenzweig, 2007) nevertheless it appears to continue to influence practitioners. However, the collapse of Enron on December 3, 2001 (Bryce 2002; Eichenwald 2005) shifted the direction of the lens through which much of business success is now examined. Suddenly the corporate board had become important. Although the recognition that governance may be *a source* of wealth creation began emerging a decade earlier with the publication of the *Cadbury Report* (1992). The same shift in attention appears to be now occurring in the SME and family business domain (Swinnen et al. 2010).

The limitations to knowledge of effective governance (Lockhart 2010) are due to two phenomena. The first is to do with the respectability (Gummesson 1991) of research methods. The second limitation is to do with access. Respectable research typically involves the use of large-scale data sets and the search for relationships with the hope of eventually identifying causality between variables. In this case effective governance is reduced to a pseudo-linear input output model. Despite perceptions to the contrary little of this research has been revealing to date. For example, there is as yet, no systemic support for the view that independent directors (determined by the absence of stockholding) add value. The second limitation is due to the difficulty of accessing the 'board room'. Only in rare instances have researchers entered the boardroom, or a proxy site for the board room. Hence the mystique concerning what really goes on (Leblanc & Gillies 2004). Does a board really add value, if so how? Some boards appear to add considerable value, while others are culpable of significant wealth destruction (Lockhart & Taitoko 2005; Healy 2003).

There has been little research on the governance practices, its effectiveness, or the governance needs of small to medium-sized enterprises (SMEs). By contrast the succession planning literature (Davis 1968; Handler, 1990, 1994; Lansberg, 1999; Dyck, Mauws, Starke & Mischke, 2002) is relatively abundant. Even less research has been completed on the governance of rural business that also happen to be both SMEs and family firms (Reid, 2004). Therefore, we know little about what is happening, and little attention has been paid to their needs, up until now. Although some local research concerning succession planning among agricultural businesses has been undertaken (e.g., Keating & Little 1994; Little & Taylor 1998).

Because of the limitations of research, as identified above, recommendations for boards are typically based on structure and form, including easy-to-measure externally recognisable attributes concerning directors. Hence, the near constant recommendation for independent directors as best practise (Institute of Directors in New Zealand 2007), a characteristic of mature governance. But while their incidence is measurable from the outside their systemic contribution is unknown (Leblanc & Schwartz 2004; Ramaswamy, Ueng & Carl 2008). Therefore, whether or not those recommendations of structure and form (best practise/mature governance) are optimum for providing effective governance for an organisation is, for the time being anyway, debateable, and could be even limiting practice (Ghoshal 2005). Rather, if good organisational governance is to be achieved (Pound 1997; Wong 2011), when governance is defined as effective collective decision-making for enhanced company performance, directors must be selected on the basis of how their competencies and behavioural characteristics complement each other and how they enhance the strategies an organisation has for achieving its purpose (vision) (Collins & Porras 1994). Therefore, regulatory agencies and other groups involved in establishing the framework of governance may find it worthwhile to consider the mix of behavioural characteristics and the skills, aptitudes, and capabilities of directors within boards. This approach is expected to have a significant impact on the family business environment (Elstrodt, 2003; Dorgan, Dowdy & Rippin, 2006) as dynamics of decision making, succession hierarchy, and implicit expectations are likely to be challenged.

DATA SOURCES

During 2010 the researcher met with some 700 SME owners, representing about 400 businesses in New Zealand's agricultural sector and discussed with them the attributes of their businesses' governance. This opportunity was the result of a substantial executive education contract held between Massey University and New Zealand's largest rural financier. Day long workshops were hosted at 18 sites throughout provincial New Zealand. Each workshop was attended by about 30 - 50 business owners including spouses, their children and/or siblings. Business owners were specifically invited by their financier because they were either pursuing a growth 'strategy', confronting family succession, considering exit or had recently diversified their land holdings. In summary, they were considered to own businesses that would benefit from more formal/mature governance, the adoption of best practises, and were also considered to be personally receptive to management learning (Burgoyne & Reynolds 1997).

The technique of enquiry learning (Siebert & Daudelin 1999) was used to stimulate discussion among participants by the researcher concerning the benefits, attributes, and implementation of more formal/mature governance practices. In that respect the 18 workshops represented informal focus groups (Merton, Fiske, & Kendall 1956; Wilkinson 1998; Överlien, Aronsson & Hyden 2005). Results were captured through written surveys completed at the time, and verbal and physical acknowledgements in response to specific questions. The processes of critical reflection (Schön 1987), anticipated by the financier, resulted in full participation at each workshop, and when conducted, a 100% survey response rate was achieved.

Given the nature of participant selection there is the likelihood of bias. Those invited were considered to own businesses considered likely to benefit from the adoption of more formal governance[1]. Therefore, while there was no compulsion to attend there was a heightened degree of receptivity to the discussions that followed. Therefore, relative to the population this sample was expected to be better informed, more receptive to change, willing to learn, and more eager to contribute than their peers having demonstrated these attributes to their financier. Therefore, any bias is likely to *favour* the attributes of either governance or entrepreneurship over the larger population of New Zealand farm business owners.

RESULTS

The majority of businesses were held as companies, trusts or some combination of company and trust (94%). The most common model was found to be one where the physical assets were held in a family trust, with a company responsible for trade (72% of participants). The owner-operator as a sole trader was found to be very rare (6% of participants). Only on rare occasions was third party equity capital held by the business, and equally rare were

[1] More formal governance included best practice structural changes, and separation of responsibility between shareholders, directors, managers and labour. The workshops were also used to introduce the Basel III accord, a shift to risk based pricing that requires mitigation on behalf of business owners.

independent directors or other features of best practice governance (including formal planning and reporting). Governance appointments external to family members, as business owners, were often bestowed on ‘family’ accountants (21%) and ‘family’ lawyers (11%). The inherent conflicts of interest of having service providers in these appointments was not recognised by the business owners. Nor was enhanced formality of process perceived through their appointment, namely, that the appointment of *close* professionals to family boards and trusts did not necessarily result in the adoption of formal planning and reporting procedures.

Davis (2007: 1) observed that the legal obligations of a family business are ‘few in number, but very important’. In New Zealand, like most other ‘Western’ jurisdictions these are limited to an annual company return, election of directors, and appointment of the auditor (Companies Act, 2010). In practise, annual returns were observed to be completed online by either a company director/business owner cum manager or by the company’s accountant (a highly automated task). No election of directors was found to occur among participants as they were almost always appointed at the time of the company’s registration, except when multiple generations of family were involved. Business owners, through their role of shareholders were never observed to appoint an auditor (except perhaps during patrimonial disputes, with one reported incidence among the 450 businesses involved).

Only rarely was a vision, or statement of purpose written down, which occurred with some 10% of participants. Formal planning was limited, and typically included nothing more than an annual cash-flow (23% of participants), and or production forecast (17%). Formal evaluation of financial performance was also rarely undertaken. Changes in balance sheet position were noted from annual tax accounts, and/or calculated from the value of land sales in close proximity. Debt positions were reported by the financier on a monthly (current liabilities), or annual basis (term liabilities) leaving reasonably simple calculations to be undertaken by the business owners.

DISCUSSION

Numerous reasons were sighted by the workshop participants to justify the dominant form of business structure that they had adopted. These reasons included the view that trusts were an appropriate vehicle for both asset protection and tax minimisation. Companies were seen as more appropriate to limit risk from potential financial liability brought about through annual trading activities. Seldom did workshop participants express the view that the business's legal structure was adopted for the purpose of business growth – despite many of them being selected by their financier due to their commitment to such growth. Whether trusts provide the form of asset protection that they may have once done or tax minimisation for beneficiaries is debatable. New Zealand has, by global standards, liberal matrimonial property law, and the beneficiary income of minors (U16) has been taxed at corporate rates for the last decade.

The governance structure of trusts and companies held by the workshop participants also displayed consistent sub-optimal patterns. Beyond the providers of equity capital, typically the farming couple or family, appointees as trustees or company directors were most often the farm family's accountants and/or lawyers. While the motivation for such appointments was recognisable, they are the two best known 'professionals' to rural businessmen and women, it potentially sets up a conflict of interest that needs to be managed. It would be highly irregular to find a corporate (listed) business where the company lawyer or accountant, or those of substantial shareholders sat on the company board. In fact, the independence of service providers from the baordroom is one of the globally consistent recommendations of best practice to emerge post-Enron.

Governance is much more about effective collective decision-making than it is about structure and form (Ward 2004; Huse 2007: Peebles 2010; Wong 2011). New Zealanders appear to be notoriously poor at building great companies. Few of the iconic companies established in the 19th Century remain. As a nation business owners appear to spend considerable time and entrepreneurial effort getting to what could be widely regarded as being *first base*; an entity with some $4 - 8m of equity; operational systems and processes; reasonable returns (in cash and wealth creation); good employees; and, typically some form of local market presence. In the case of those rural entities participating in this study the equity base was often higher, and it is the global market being served, through societal marketing boards (Izraeli & Zif 1997), farmer-owned cooperatives (Hansmann 1996), closely-held companies, or the occasional listed corporate. At the stage when the company should be transitioning from an entrepreneurial form to something more formal, with a formal – but not necessarily cumbersome - governance structure owners appear to be willing to sell. The rural business involved in the study seldom offered an alternate view, especially where the linkage between governance and succession planning was at the point of being discussed. Rarely was more formal governance considered to be related to business growth, the understanding sought by the financier, and increasingly expected by the Basel III accord.

Much is to be learnt from what formal governance (Carver & Oliver 2002) has to offer SMEs. The mere discipline of planning and reporting on performance, say quarterly, is suspected to be of benefit to most of the rural businesses in this study. But there remain considerable prejudices among participants about what directors can and cannot do. Real concerns were expressed over the loss of control by introducing an independent director(s). Similarly, the rights and responsibilities of shareholders were not well understood. To say nothing of the increasing need to separate these functions.

At the very minimum considerable value could be achieved by simply making the existing legal entities operate in the way they were intended. This will include the recognition that companies are the globe's preferred vehicle for business growth (Micklethwait & Wooldridge

2003), not trusts. However, the roles and responsibilities of their shareholders, their directors, their management, and their employees need to be considerably better understood by this group of participants. Operationalising shareholders' meetings, board meetings, and management meetings was considered onerous by many of the participants involved.

CONCLUSIONS

We actually know little about governance. The relationship between good governance and subsequent business performance has not been established. However, business failures, such as, that explored by Lockhart and Taitoko (2005), typically reveal governance failure. Recommendations for boards, designed to improve governance, invariably surround structure and form. They could well be improved by addressing effective decision-making for good company performance. In doing so these recommendations may better attract the attention of SME owners, who appear to view them as being largely irrelevant.

In most SMEs and family businesses owners hold multiple roles, such as, director, trustee, shareholder, beneficiary, general manager, and/or labourer. Immediate improvements could be achieved by conducting of these roles in isolation of each other. Exemplary companies, both in New Zealand and abroad, regardless of scale, appear to have *all* adopted more formal - mature - governance processes. Anecdotally the relationship exists. Research should now attempt to identify whether causality can be established between exemplary companies and their adoption of formal governance.

SMEs in the agricultural sector in New Zealand, despite making a disproportionate contribution to the economy, are currently deficient of the most common attributes of business governance. While this may not be harmful to business performance in the short term it does raise the question of missed opportunities.

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