The Value of Corporate Governance to Small Businesses in Australia

ABSTRACT

This paper argues that a study of small busineses in Australia provides evidence that the traditional application of agency theory and governance principles were only marginally relevant to small businesses. The study determined the relevance of corporate governance principles to small businesses in Australia. Small businesses, comprising over ninety six percent of all businesses contribute significantly to the economic wellbeing of Australia. Small business owner/managers and CEOs of small business associations were surveyed. The criteria for assessment of governance practices were derived from ASX corporate governance principles and the Corporations Law. The study investigated board structure, leadership, independent directors, and board committees in small businesses and revealed other governance related difficulties.

Keywords: Small Business, Corporate Governance, Small business governance, Regulation, Boards

INTRODUCTION

Commonly referred to as the "engine room" of the economy, small businesses are a potential driver of innovation and economic growth in Australia. However, small business are very susceptible to major economic fluctuations. In difficult times, such as the Global Financial Crisis (GFC) they are the suppliers, the creditors and customers at the end of the corporate value chain. As a consequence they suffer the most from credit crunches, the loss of revenue, the loss of skilled staff and uncertainty in customer production and service demands.

According to the Australian Bureau of Statistics (ABS 2010) there are approximately 1.99 million small businesses, representing ninety six percent of all businesses, employing over 5 million people. These small businesses account for around fifty one percent of private sector employment and contribute to over one third of Australia's total GDP. Because they make up the vast majority of the businesses in the Australian market, they are vital in economic, social and cultural contexts.

Agency theory (suggests that there is a potential conflict of interests between the owners of a company (the principals) and management (their agents) (Clarke, 2004). Corporate governance best practices have been widely promoted as a means of making executive directors accountable to their owners and have been proposed as a means of reducing risk and improving efficiency . (Australian

Securities Exchange 2003, 2009) Recognising their importance to the economy, this study aimed to determine the value of corporate governance for small business in Australia, through investigation of the views of small business owners and regulators. This paper describes the characteristics and definitions of small business, followed by definitions of corporate governance, the methodology of the study, and the results. It concludes by drawing some conclusion about the value of governance principles to small business.

CHARACTERISTICS OF SMALL BUSINESS

Small Business can take the legal form of a sole proprietorship, a partnership or a company. Many are registered as companies and ownership is often restricted taking the corporate form of sole proprietorships or partnerships. These latter forms leave the small corporations without the protection of limited liability.

A number of different characteristics have been identified in the literature in relation to small business (Francis and Armstrong, 2006). For example: they have a relatively small share of their marketplace and often operate in only one location servicing local customers but may operate in a niche market or be part of a franchise.

Usually they are owned by one person, or a small number of individuals, often linked by family ties.

In the USA family businesses represent 35% of all businesses, in Europe over 50% (Faccio and Lang, 2002) and in Asia over two-thirds of businesses (Claussens et al 2002). 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 a larger corporation. They are closely associated with entrepreneurship and innovation (Muenjohn et al 2010).

Because an owner/manager undertakes most management roles without the support of internal specialists, the small business is often dependent on other professionals such as their accountant or

lawyer for advice (Heenetigala and Armstrong, 2010). Small businesses are primarily susceptible to a number of problems. In relation to ownership and management, succession is often a problem with small businesses (Hartel, Bozer and Levin 2009). Access to financial and other resources is often a major constraint (CPA, 2008). Finally, they are independent, in the sense that they are not part of a larger enterprise. In fact, some are deliberately kept small because their owners value the life style associated with "less hassles, less politics, more flexibility and better work-life balance (Rudd, 2008).

DEFINTION OF SMALL BUSINESS

Academics and policy makers have looked for objective definitions of small business. Among the variety of criteria used to define small business are total net worth, relative size within the industry, number of employees, value of products and annual sales or receipts (Cochran 1981). Because of the range of definitions that have been used, it is extremely difficult for researchers to compare the findings from different small business studies (Burgess 2002). What is classed as small in one study may be medium in another and large in yet another study (Burgess 2002).

The ABS defines small business as one that employs less than 20 people and medium as one that employs between 20 and 200. Micro businesses are a special type of very small businesses defined by the ABS as employing less than 5 employees. Often the issues that face small businesses are dealt with under the heading of small and medium sized enterprises. SMEs (small and medium sized enterprises) are a combination of small and medium sized businesses. But issues that arise in relation to small business are different from medium sized businesses. Freedman (2009) refers to small business as an "owner-managed business with ten employees, whatever its legal form".

However, the definition of small companies adopted in this study was that of s45A(2) of the Corporations Act 2001 (Cth): corporations with less than 50 shareholders which meet at least two of the following criteria:

- consolidated revenue of less than $25 million per year;

- gross assets of less than $12.5 million;
- fewer than 50 full-time employees.

Under this definition, around 98 per cent of Australia's 1.6 million proprietary companies are classified as small and, with some exceptions, do not have to prepare annual financial statements and lodge them with ASIC. However, there are over 30,000 small and medium companies which must meet the full regulatory requirements (Miller, 2010).

CORPORATE GOVERNANCE AND SMALL BUSINESS

In order to examine the corporate governance of small businesses, this paper will firstly examine corporate governance in general. Corporate governance is concerned with the internal structures and processes for decision-making, accountability, control and behaviour at the top of organisations (International Federation of Accountants, 2001, p. 3). It is essentially about the control and direction of companies, exercised by their directors and those holding power and authority, and includes any decision making in all those matters which affect the vision, performance and long term sustainability of an organisation. In addition to board and organisation infrastructure, that includes systems of control, these can include other matters such as investment decisions, risk management, and environmental, social and governance responsibilities (ESG) (ASCI, 2011;Santos, 2011). These are beyond the scope of this paper.

There are various definitions of corporate governance. The OECD (2004) defines corporate governance as

"the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs".

The Australian Securities Exchange (ASX) corporate governance council first issued its Principles of

Good Corporate governance and best practice recommendations in March 2003 with a revised edition in 2009. It states that corporate governance is a system by which companies are directed and managed. It influences how the objectives of the companies are set and achieved, how risk is monitored and assessed, and how performance is assessed. According to Recommendation 2 of the ASX corporate governance principles, companies should have a board of an effective composition, size and commitment, to adequately discharge its responsibilities and duties. It also states the majority of a board of a listed company must be independent and the role of the Chair and the CEO should not be exercised by the same individual (ASX Corporate Governance Council 2003).

The main theoretical focus of governance research is drawn from agency theory, which owes its origin to the need for companies to seek investment outside a company to support further development and growth. This led to the emergence of many owners and the separation of owners and control (mangers). Investors take the risks while managers end up with “substantial residual control rights, and therefore discretion over how to allocate investors funds” (Clarke, 2004, p5). Agency theory assumes that a problem occurs because managers (the agents) will act in their own interests and that these may conflict with those of their shareholders (the principals). Hence, there is a need for shareholders to monitor and control the managers. Best governance practices are intended to meet this need. This paper reports a study that investigated the relevance of these to small business.

Governance of Small Businesses

As stated above, governance is about the decision making and control exercised by those who are in charge of a corporation. The *Corporations Act* 2001 (Cth) uses the term “Director” in referring to those legally appointed to a board and responsible for the duties and responsibilities of directors, but owners and managers of small corporations see themselves as ‘owners and managers’ rather than as ‘directors’. When the roles of management and ownership are located in the same person, the agency problem does not emerge and agency theory does not offer an appropriate explanation of governance in small corporations.

Besides size, assets and level of employment as described above, the Corporations Law distinguishes in other ways between small and large companies. Adams (2010) describes a major distinction between small and large companies related to the level of disclosure required by the regulators and the requirement to produce formal accounts and auditing. A small proprietary company under s292(2) generally does not have to provide a financial report nor a directors' report unless there is a direction (request) from the shareholders (s293) or ASIC (s294). However, all companies, including small proprietary companies have an obligation to keep financial records under s286 *Corporations Act* 2001 (Cth). The financial records must correctly record and explain all transactions and the financial position of the company and would enable a true and fair financial statement to be prepared. The records must be kept for seven years and it is a strict liability for a criminal offence to fail to keep such records. This obligation is in addition to any tax law provisions. Directors of both small and large companies are subject to a wide range of responsibilities and liabilities under the general common law duties and duties under the corporations Act 2001. They can be personally liable for breach of these laws, including occupational health and safety, taxation, environmental laws and trade practices.

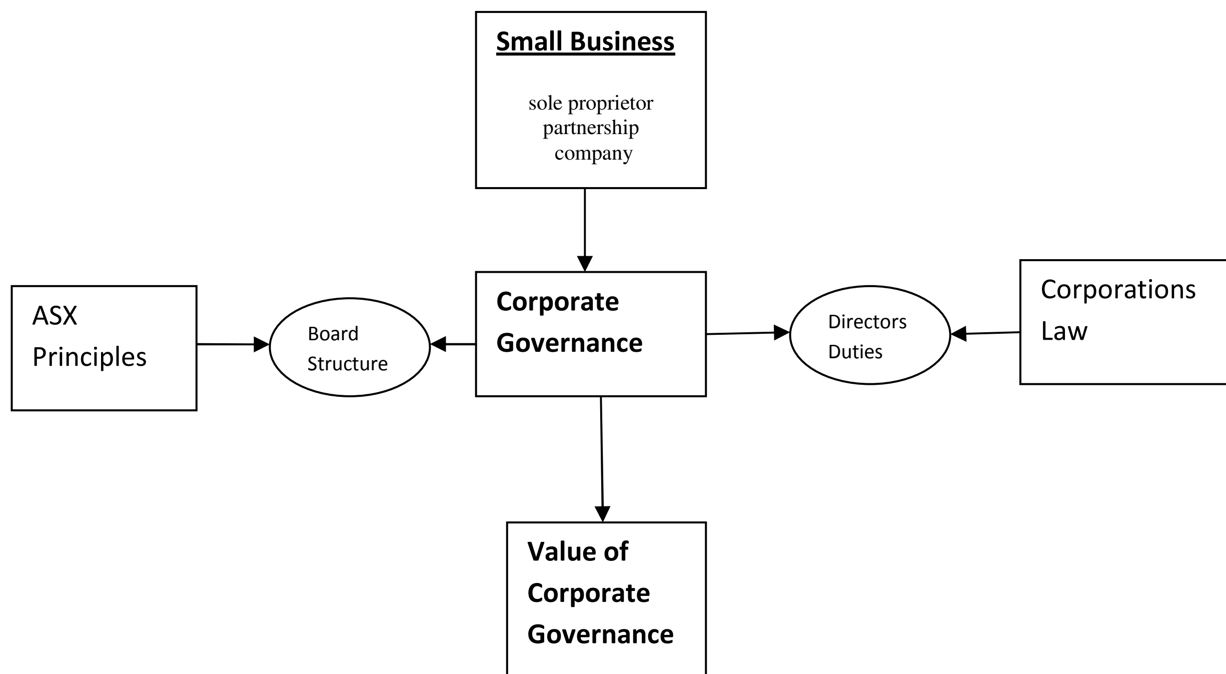
There are other ways in which corporate governance in small corporations differs from that found in larger businesses. These include decision making, ownership and board structure and composition. ASX best practice guidelines on corporate governance refers to the separation of chairman and CEO, boards with independent directors, board committees, the separation of ownership and control, appropriate skills and diversity of directors, a code of conduct and record keeping and audited annual reports. As small business is usually controlled and operated by the owners who in many cases does not even have a board (Armstrong et al. 2011) these governance mechanisms are often inappropriate and are more relevant to large listed companies.

CONCEPTUAL FRAMEWORK

The ASX Corporate Governance Best Practice Principles were intended to guide the implementation of best practice in governance for companies listed on the ASX, but many of the Principles, such as the structure of of boards and directors duties, are similar to the regulations of the Corporations Law. The conceptual framework for this study was based on a combination of the corporate governance mechanisms of board structure comprising leadership, composition and board committee, regulated under the ASX corporate governance best practice recommendations, and directors duties regulated under corporate law.

The proposition investigated in this study was that the match, or discrepancy, between the principles and regulations and the empirical practice of governance in small business was an indication of the value of governance to small business.

Figure 1: Value of Corporate Governance for Small Businesses



METHODOLOGY

In order to assess the value of corporate governance for small businesses, this study employed both quantitative and qualitative techniques. It was part of a larger study supported by an Australian Research Council (ARC) grant which investigated the governance regulation in small businesses (Armstrong et al. 2011). It was conducted in Victoria where the twenty one participants were nine owner/managers of small businesses and twelve executive directors of small business industry associations.

The sample was a purposive sample selected because of their in-depth knowledge and experience of small business. The majority of the small business respondents in this study were male (77.7%) and 22.2% were female. The highest level of education achieved by the participants was a bachelors degree (33.3%) and 22.2% had post graduate qualifications and a further 22% had only secondary education. Over 50% in this sample were qualified.

Interviews were conducted using a structured interview schedule containing both closed and open ended questions. The opinions and experiences of respondents were reported on a 1-7 level scale and responses were provided for in-depth explanations. This gave participants the opportunity to provide comments as well as raise issues that would be useful in the analysis and provide insight into the issues.

Most of the survey was conducted by telephone and few respondents opted to email or mail their responses to the surveys. The quantitative data were analysed using SPSS to produce descriptive statistics and qualitative data were content analysed. The following section will discuss the results of the analysis.

RESULTS AND DISCUSSION

Value of a Board to Small Businesses

This study investigated the value of a board to small business. In general a board represents the interests of shareholders. Cadbury (2002) states that a board of directors is the link between

shareholders and a manager and the link between the companies and the outside world. Its task is to devise plans and policies to achieve aims and objectives and appoint and monitor executives to ensure that they are achieved.

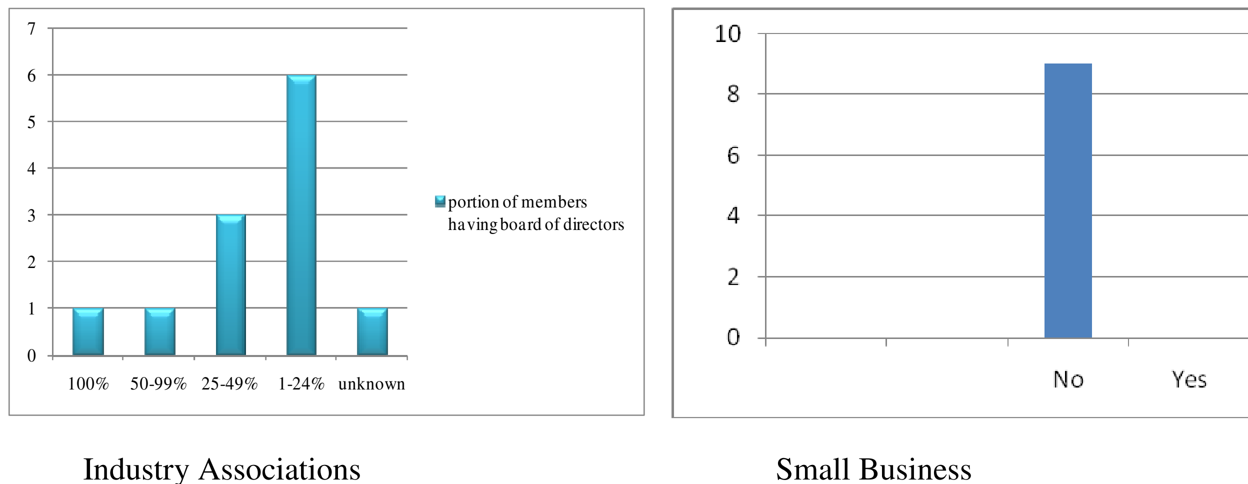
Directors form the board of a company and can only act to influence decision making if they meet as a group. The board is responsible for a range of functions. The main functions are: to define the company's purpose; to agree strategies and plan for achieving that purpose; to establish the company's policies; to monitor the organisation's performance; to appoint the chief executive; to monitor and assess the performance of the executive team; and to assess their own performance.

As noted above, the majority of businesses in Australia are small. Quite often the owner of a business will be the managing director, who handles the roles of director and manager. Although size makes a significant difference to an organization's legal environment, it does not change the legal duties and responsibilities of directors, even though the scale of operation differs between large companies and small businesses. Hence, the respondents reported difficulties with regards to directors' duties in relation to: rules for the directors which are so difficult to understand; concern about the level of liability/criminal sanctions regarding directors and the assumption by ASIC that directors understand their responsibilities; too much accountability requirements, and a limited ability to fund directors that resulted in difficulty in attracting high quality directors. Furthermore, and most importantly, the above results and the responses to questions about small business owners as "Directors", indicated that many did not recognise that even though they were a single owner/manager, they also had directors' responsibilities under the Corporations Law.

In this study eight of the nine small businesses were proprietary companies. The exception was one which was a partnership. Six had a single owner manger who was the sole director. In most cases the board members were shareholders or members of the family who owned the business. It appears that a board was formed when there were more than two shareholders and that these then became the board members.

Six industry association CEOs reported that less than a quarter of their members have a board of directors. Only one association, the largest, reported that all their members had a board in place. Three estimated between 25% to 49%, of their members have a board of directors. One respondent disclosed that more than 50% of their members have a board of directors. None of the small businesses had a board of directors (figure 2).

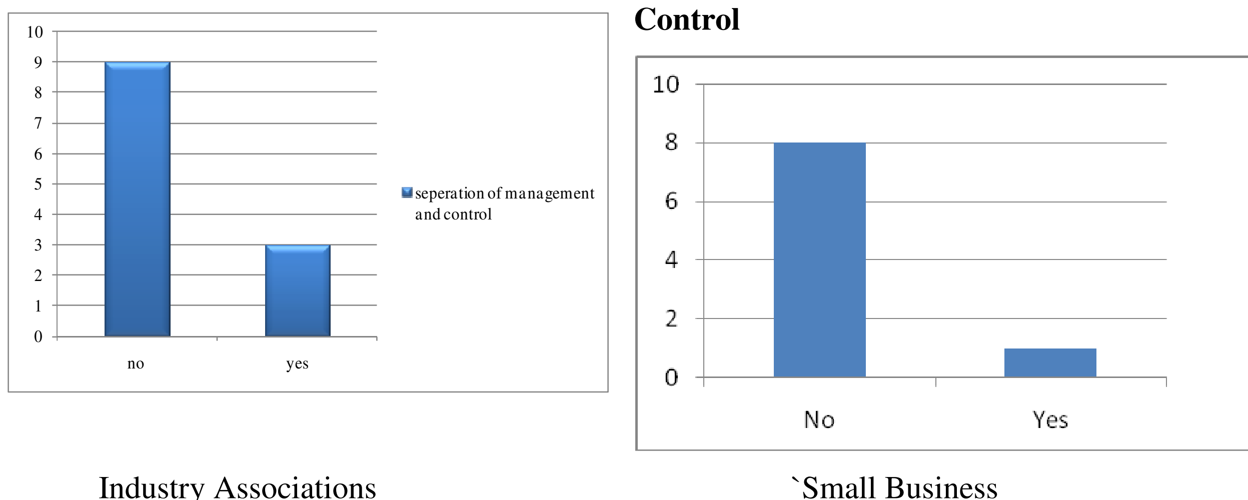
Figure 2: Proportion of Small Businesses with Board of Directors



Industry Associations Small Business

In relation to separation of management and control, only three of the CEOs of industry associations reported that their small business members separate management and control, whereas only one small business reported that they separated management and control. This shows that due to their characteristics majority of small businesses did not separate management and control (Figure 3)

Figure 3: Separation of Management and Control



Industry Associations `Small Business

Value of Independent Directors to Small Businesses

Secondly, the study investigated the value of independent directors to small businesses. Independence of a board is regarded as the ability to make decisions independent of managment, and to monitor management. The latter is seen as an important governance best practice in the ASX Principles. In order to enhance the independence of the board, the mechanism employed is to have a board composed of executive and non-executive directors. ASX Principle 2, Recommendation 2.1, states the majority of the board should be independent directors. It states that an independent director is a non-executive director who is not a member of management and free of any business or other relationship that could materially interfere with or could reasonably be perceived to materially interfere with the independent exercise of their judgement (ASX Corporate Governance Council 2003).

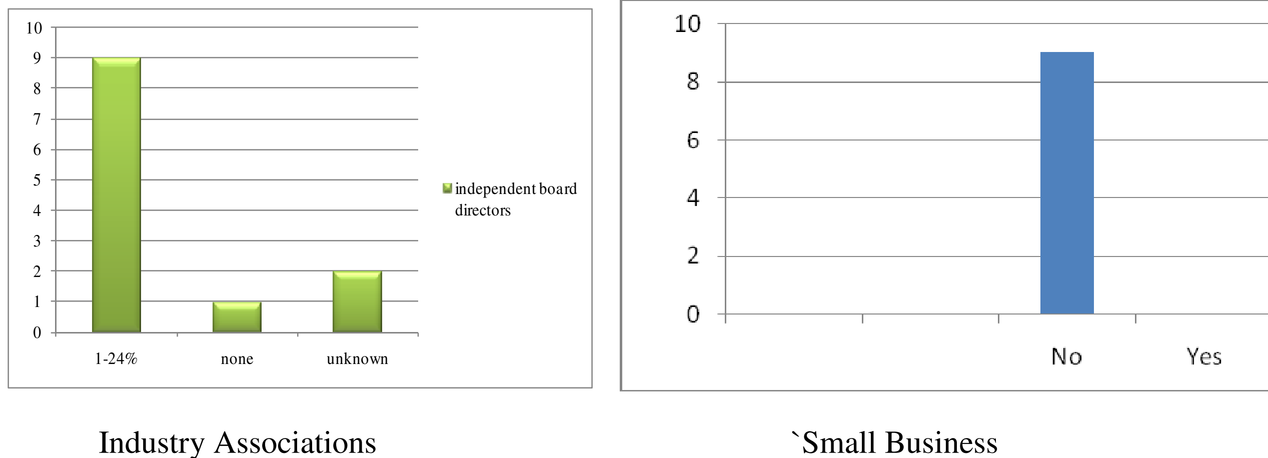
Even though the key responsibility of the non-executive directors is the monitoring role (Cadbury 1992), they also provide many other advantages. In large companies they bring in a wide breadth of knowledge, expertise and contacts, which may enhance the ability of management to secure scarce external resources, as well as the independence they have from the CEO (Kesner & Johnson 1990).

For small businesses dominated by owner/managers, the point of appointing independent directors to monitor management seems superfluous. Further, it is debatable how much value independent directors add to small businesses when their cost is taken into account.

Nine industry associations CEOs reported that less than 25% of their members have an independent director sitting on the board. The other three respondents said the proportion of their members having an independent director is either zero or unknown.However, none of the small businesses surveyed had independent directors (figure 3).

The results appear to confirm ASX surveys and previous research (Clarke and Klettner 2009) which showed that even many listed SMEs do not invest in independent directors. Most of the entities assessed in this study not only did not have independent directors, but as noted above, they did not have a board.

Figure 3: Proportion of Small Businesses with Independent Director



Industry Associations `Small Business

Value of Board Committees to Small Businesses

Cadbury (1992) highlighted the importance of board committees and proposed that sub-committees of the board should focus on specific aspects of governance that are considered problematic. His Committee recommended that boards should nominate sub-committees to address the following three functions: audit committees to oversee the accounting procedures and external audits; remuneration committees to decide the pay of corporate executives; and nominating committees to nominate directors and officers to the board. The ASX Corporate Governance Principles also recommended that boards include sub-committees.

Unlike large businesses, most small businesses do not have a number of owners. They are mainly managed by one owner, who is also the manager, and most decisions are made by one or two people, mainly the owner/ manager. As confirmed above most do not have a board. Therefore establishing board committees may not be possible for most small businesses. As a result, problematic issues are usually performed by outside consultants such as accountants. External experts may be expected to provide compliance services, prepare accounts, give accounting-related advice, show concern for clients' financial health, actively seek out client problems, and give general business advice.

In this study, most of the CEO respondents mentioned that their members do not have any sub-committees. Some said they are not clear whether their members have such sub-committees or not.

Others acknowledged that some of their members may have audit committee, risk management committee, remuneration committee or nomination committee, but the proportion would be less than a quarter. Among the small business respondents, one reported having a risk management committee and one had a remuneration committee.

Governance Related Difficulties

Small businesses also reported governance related difficulties in relation to corporate registration, governance regualtion and record keeping.

They reported that compliance with corporate regulations was in many cases left to accountants due to encountering the following difficulties: time frames for reporting were too short; penalties were disproportionate compared with an offence; ASIC was too inflexible for small business management; ASIC should send out notices confirming charges applied by a bank; ASIC and ACCC language is confused and convoluted; ASIC provided poor phone advice and; ASIC was not tune with modern IT.

Respondents also reported major problems with governance regulation. From the point of view of small business, they were: lack of knowledge of the regulations; lack of understanding of the regulations; lack of appreciation of the difference between the owner/manager and the company as a separate entity; lack of understanding of what it means not to comply with directors duties and governance regulations; lack of skills in dealing with regulators; reliance on accountants or lawyers and the costs involved. On the other hand regulators view of governance regulation was reported as follows: inappropriateness of regulation to small business; lack of understanding by ASIC of small business points of view resulting from poor communication, resulting in poor compliance; failure of government to communicate efficiently with small businesses about corporate governance; the regulation and corporate governance requirements are intertwined; businesses find it is difficult to capture the latest requirements.

In relation to difficulties faced by small businesses, with regards to record keeping were: rules for record keeping are complex and difficult to understand and follow; keeping records is time

consuming; and lack of the skill set to prepare financial documents requires small businesses to use accountants.

Other Corporate Governance Issues

A board became necessary when a company had more than one shareholder. Then the owners usually took a seat on board due to the need to exercise control over their investments. This confirms previous research which suggested that this happened when a company had moved to a more 'mature' stage of development. In practice this seems to be when the number of employees increases and the amount of regulation with BAS, OH&S, etc grows.

As stated above the majority of small companies were managed by the manger/owner who in many cases was the sole director. Hence, the separation of management and control was not an issue. Indeed, it may have been seen as strength of much small business, because the ability to make quick decisions allowed flexibility and speedy responses to consumer demands.

Two initiatives that could (a) promote good governance and (b) monitor performance are a code of conduct and independent auditing. Half of the small businesses said that their companies had a code of conduct. Only two of the twenty one respondents reported that their entities were audited. This is not surprising given the small size of both associations, the small businesses in the study and the lack of regulation requiring auditing. However, as associations are responsible to their members both reporting and information distribution could be expected to be an important parts of their functions

In general, although the industry associations members had on various occasions been exposed to their associations financial and operating information, share ownership and voting rights, and foreseeable risk factors, most small business members disclosed information about their companies only to their accountants or for tax purposes. In relation to succession planning, only four of the responding entities had an established succession plan.

The above description of the small business sector presents a rather diverse picture of a sector that is not overly concerned with corporate governance regulations or best practices.

CONCLUSION

In this study we investigated the value of corporate governance for small businesses in Australia, because they play a vital role in the national economic and social wellbeing. The study sought the views of small business owner/managers and CEOs of small business industry associations to form conclusions about the value of corporate governance for small businesses in Australia. It investigated boards, independent directors, and board committees in small businesses. Furthermore this study revealed other governance related difficulties faced by small businesses.

Few small businesses reported having a board and consequently independent directors, and sub-committee structures were rare. Only 25% of the small businesses represented were believed to have a board. For many small businesses a board is seen as not applicable or not necessary.

The above results showed that the small businesses were not concerned about corporate governance practices, because quite often a board was unnecessary and businesses were mainly managed by an owner/ managers. Therefore separation of ownership and control was not an issue for small businesses.

However, as owner/managers they were also directors of their businesses. As the Corporations Law imposes duties on directors small business owners have a duty to act with reasonable degree of care and diligence, and duty of loyalty and good faith to their businesses.

Consultation by regulators with the small business sector is important in order to encourage them to understand small business corporate governance needs. One option is to design a simpler code of corporate governance best practice relevant to small businesses. This would result in not only understanding their responsibilities as directors under the corporations act, but to remove unnecessary regulation of their sector.

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