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# "One Size Doesn't Fit All" – A Review of Corporate Governance Guidelines with an SME Perspective

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*Corporate governance regimes such as the Sarbanes-Oxley Act (2002) in the US, the Australian Stock Exchange (ASX 2003) Corporate Governance Council's Guidelines, the Combined Code (2003) in the UK, and the enacted and other provisions proposed in CLERP9 (2004), reflect pervading beliefs - that the majority of business is undertaken by large listed public companies, and governance regimes necessary and appropriate for big business are necessarily appropriate for small business. Arguably, a substantial part of international commercial activity is undertaken by Small and Medium Enterprises (SMEs), and as such are an important element of the economy. With corporate governance regimes' focus upon compliance with accounting and auditing standards, company board structures, participation of executive and independent directors, auditor independence, and having audit committees with prescribed structures, and the like, they are of little significance in respect of SMEs' affairs. The paper will examine the relevance of current corporate governance regimes to SMEs; that is the hypothesized irrelevance (for most purposes) of the themes underpinning the corporate governance regimes currently in vogue in respect of the commercial affairs of SMEs.*

**Field of Research: Corporate Governance.**

## 1. Introduction

*Corporate Governance* is not a new concept. But, the spate of recent large scale corporate collapses has been a catalyst for popularising the prescription of governance regimes intended to ensure managers act for and on behalf of not only shareholders, but also a with a wider focus on broader stakeholder issues (Monks and Minow 2004). Governments worldwide are issuing corporate governance guidelines and legislating *best practice* rules, especially designed to prevent large listed corporations from suffering the financial distress of the kind experienced recently by the likes of the Maxwell Group and Polly Peck in the UK, HIH, OneTel and Harris Scarfe in Australia, and Enron, Sunbeam and WorldCom. in the US.

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Generally however the plethora of corporate governance prescriptions has been directed at the affairs of large and listed entities, and primarily, only by default, been assumed to apply to all entities, in a broader sense. Issues such as the equitable treatment of shareholders, director's duties, the *independence* of corporate officers, sentencing and penalty regimes, are indicative of the tenor of the corporate governance issues being discussed. *Good* corporate governance is being said to be 'good for business', *good* for all businesses irrespective of their structures, implying in that context the serviceability of a *one size fits all* regime. But what is *good* corporate governance is contestable. And the one size fits all proposition, even more so. Indeed, what is good corporate governance for big business has not been shown equally and necessarily applicable to Small and Medium Enterprises (SMEs).

SMEs are not as complex as big business, and generally have structural and managerial characteristics quite different from those of the publicly listed companies that have been the focus in the development of the corporate governance regimes imposed by governments and the securities market regulators. Yet, the SMEs are very important in terms of employment (74% of the Australian workforce) and small business alone contribute to economic growth (25% of overall operating profit) and to the Australian economy (ABS # 1321.0.55.001, 2001).

Overall, the corporate governance literature invites two inferences, that:

- the majority of business is undertaken by large business; and
- what is good for large business in terms of corporate governance regimes, rules and practices is, by default, equally appropriate and applicable to SMEs.

This study addresses those inferences and focuses on the applicability of current corporate governance regimes to SMEs.

## 2. Underlying Literature and Theory

Corporate governance guidelines aimed at larger listed corporations have been issued both in the Australian and international contexts, those by the OECD (Organisation for Economic Co-operation and Development 2004) the Australian Stock Exchange Corporate Governance Council's *best practice* Guidelines ( ASXGCG 2003), the UK's *Combined Code* (CCUK 2003), and the Sarbanes-Oxley Act (SOX 2002) in the US, being repositories of the most important corporate governance principles underpinning current regimes.

SMEs have been shown to be of significance to the Australian economy (ABS 1999), this seems to be a characteristic of other SMEs worldwide. On an international level, there are 75 million SMEs which represents approximately 99% of all companies (IBM, 1997). In the US alone, more than 5,500,000 SMEs create 2 out of 3 new jobs (US Small Business Administration 2000) and create almost half of the Gross National Product and employ over half of the workforce (US Census Bureau 2000). In Japan, 69% of the workforce is employed by SMEs (Somucho 1995, Rodoryuko 1995, Whittaker 1997).

In China and Singapore SME numbers are around 90% of all businesses, with Hong Kong exhibiting 98% of all registered businesses (ACCA 2006). Although in the UK the definition of an SME is having fewer than 50 employees, they still account for

56% of employment and 52% of national turnover, with the European Union having 99.8% of business from SMEs, generating employment of 66% of all jobs (ACCA 2006). It is not hard to see the trend that SMEs play a vital role in local, national and global economies. Corporate governance initiatives for them are arguably an important aspect to SMEs remaining competitive, worldwide.

In considering the characteristics of SMEs and the definitions, it is perhaps prudent to contrast the SMEs' characteristics with those attributed to large enterprises, and note the differences between the two. *Large*, and certainly *listed*, enterprises would usually be more complex, have a larger volume of transactions, and face more compliance issues than SMEs (such as regular reporting to the ATO and the Australian Securities and Investments Commission (ASIC)), and for the *listed* corporations - quarterly reporting to the ASX. The ABS defined large business as "those businesses employing 200 or more people" (ABS 1999, p.4).

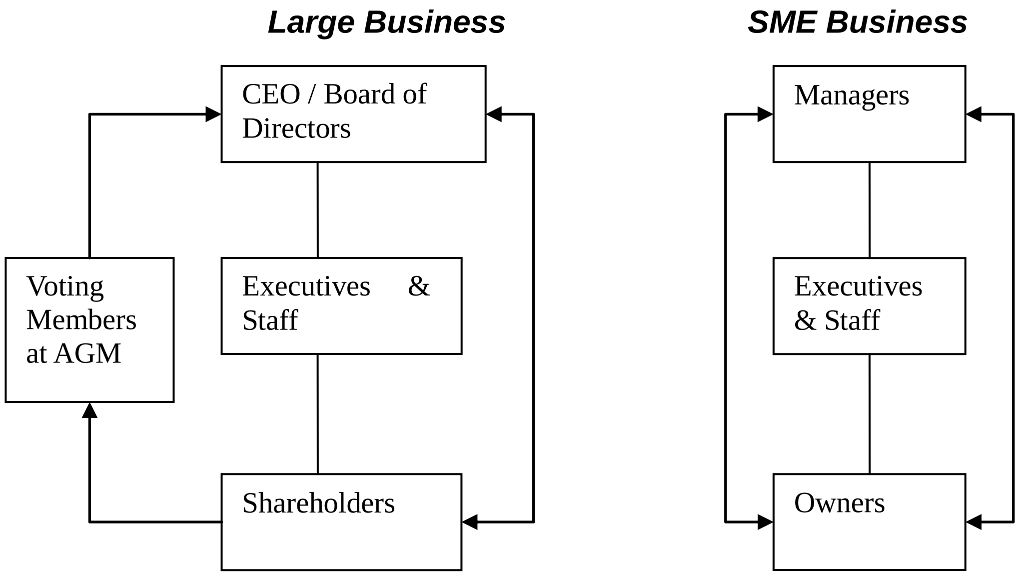


Figure 1: Large versus SME Organisational Structures

Large corporations are subject to more formal rules than SMEs, almost entirely as a consequence of their differences in characteristics. Studies by Ghobadian and Gallear (1996) and Yusof and Aspinwall (2000), for example, show five main characteristics differentiating the large and SME businesses (Table 1): *markets and customers*, *organisational structure*, *operations procedures and systems*, *culture* of the work environment and *human resources* issues.

Table 1: SMEs *v.* Large Business Characteristics

| Characteristics | SMEs | Large Business |
| --- | --- | --- |
| Markets and customers | Communication better, faster, more responsive | After sales support, competitive cost considerations, larger markets, quantity of customers |
| Organisational structure | Quick decision making, fast implementation, lack of delegation | Highly specialised, all decisions made internally, able to delegate, internal expertise |
| Operations procedures and systems | Simple flexible systems, fast response to crisis | Proper systems in place, efficiency of work, quality product and service |
| Culture of the work environment | Ability to change, unified culture, can be dictatorial | Difficult to initiate change, top-down culture for commitment |
| Human resources issues | Fewer employees, close relationship | Larger pool of resources, ability to train and invest in workers |

Adapted from Yusof and Aspinwall (2000).

Arguably, the relative idiosyncratic owner/manager relationships of listed companies and SMEs are more important than the qualifying metrics set in those prescriptions. Large enterprises thus reflect the added complexity that is related to the governance push for protecting shareholders who are not engaged in the day-to-day management processes. Management is made accountable for its actions to the (primarily) *absentee owners* to frustrate managerial opportunism facilitated by virtue of the added complexity of the separation of management and control, the profit motive is emphasised and the interests of other stakeholders are demoted as softer concerns.

As the ABS confirms, SMEs constitute the majority of business carried on in Australia in terms of employment (ABS #8141.0, 1999) and contribution to economic growth (AeBN DIST 1998), it is thus imperative that corporate governance principles and guidelines be developed specifically for application by SMEs to encourage their future growth. It is thus paradoxical that though SME activity contributes most to Australia's GNP, most of the corporate governance principles in force have specific application only to the publicly listed corporate sector that contributes less to the economy at large. An important element of this investigation is thus the isolating of those guidelines applicable to SMEs and providing a basis for *SME governance* policy decisions, particularly in relation to directors, so that the SME sector can continue on its path of orderly, controlled and managed growth, recognised as so important to the International economy.

## 3. Research Objectives

According to Clarkham (1992) the type of corporate governance systems vary around the world based on economic history, social assumptions and preferences, but all systems are designed to allow management to drive the business forward, within an effective accountability framework. Parker (2003) says the most important issues for the SME sector in Australia, particularly for family small businesses, include the consistent reviewing board structure and leadership succession planning. His proposition is that long term success of SMEs lie in the development of a governance structure that will support the strategic direction of the entity, using outside expertise.

The themes pervading the various corporate governance schemes not only in general do not address the specific characteristics of SMEs, they focus primarily upon matters that have at best minor relevance to the manner in which SME business is undertaken. Arguably, this reflects the underlying ‘one size fits all’ theme, and in particular its unwarranted extension that what applies to the big business environment, automatically applies to small business settings too.

Of particular note is how the validity of that theme is virtually unquestioned in the literature and has passed virtually unnoticed in the debates, enquiries, committees and the airing of the issues leading to the development of the formal governance prescriptions. Accordingly, the primary focus of this study is an enquiry into the corporate regimes for specific applicability to SMEs. The primary proposition pursued is *that corporate governance regimes with which listed companies are required to comply address issues irrelevant to the governance needs of SMEs. Thus the* ***Research Question is : Are the current international corporate governance regimes applicable in the SME context?***

## 4. Research Design

Based on the research problem being related to obtaining an explanation of the corporate governance principles applicable to SMEs, and understanding why *SME governance* needs have not been addressed, the corporate governance regimes currently in vogue will be analysed in the SME context of applicability. Accordingly a timeline will be sort to track the development of corporate governance, then four international regimes will be examined in light of the SME context to compare and contrast the *default theory* – that is that by default one-size-fits-all.

## 5. Data Analysis and Results

Using a timeline it is possible to visualize the development of some of the major international corporate governance practices as per Table 2. Notably, none can be related to events defining the characteristics of SME activity, such as overall level of economic contribution, nationally or internationally; industry participation; or employment contribution:

Table 2 Timeline of International Corporate Governance guidelines

| Date of Issue | Document Name | Event (if any) |
|---|---|---|
| 1800 BC | Code of Hammurabi | |
| 1991 | Bosch Committee: Corporate Practices and Conduct (reissued in 1995) | From the 1980s collapses eg Bondcorp and Quintex |
| 1992 | Cadbury Committee Report (UK) | Maxwell Insurance and Polly Peck Collapses |
| 1993 | Hilmer Report (Australia) | Following from Bosch Committee reports |
| 1995 | Vienot Report (France) | |
| 1995 | Toronto Stock Exchange on Canadian Board practices | |
| 1996 | Report on Corporate Governance in Hong Kong (HK) | |
| 1998 | Hampel Report (UK) | Cadbury Committee |
| 1998 | Olivencia Report (Spain) | |
| 1999 | OECD Corporate Governance | |
| 2001 | Ramsay Report (Australia) | Hilmer Report and Collapses such as HIH and One.tel |
| 2002 | Sarbanes Oxley Act 2002 (US) | From collapses of Enron and WorldCom |
| 2003 | Combined Code on Corporate Governance (UK) | From Hampel Report findings |
| 2003 | ASX Good Corporate Governance and Best Practice | From OECD guidelines and Ramsay Report |
| 2003 | AS 8000 - 2003 Standards (Australia) | |
| 2004 | CLERP 9 Act 2004 (Australia) | From Ramsay Report |

Though Table 2 is not exhaustive - for example, it does not include various national companies' legislation, stock exchange listing rules, the US Securities Act, and the

Securities & Exchange Act of 1933 and 1934, the Public Utility Holding Company Act (1935), and the Clayton Act (1976), it is informative. For, those regimes in Table 2 have been introduced as and labelled 'corporate governance' measures, creating the impression each was something new, that each added value to the generality of the corporate governance regimes in force at the time. These are the formal codes layered onto the existing legislative frameworks embodying all the fundamental principles of corporate governance In reality those listed in Table 2.2 do not contain anything not already explicit or implicit in the various pieces of legislation.
Table 3 compares the SME applicability of the dominant mechanisms in the current four major corporate governance regimes - the OECD (2004), the Sarbanes Oxley Act (SOX 2002), the Combined Code 2003 (CCUK) and the Australian Stock Exchanges Good Corporate Governance and Best Practice Principles 2003 (ASXGCG). The comparison specifically addresses two issues in relation to those regimes: (i) The ability to protect absentee shareholders, and (ii) Exposure of SME shareholders.

Table 3 Comparison of Corporate Governance Mechanisms

| *Regimes 'protective' Principles* | *To protect absentee shareholders* | *Exposure of SME shareholders* | *OECD* | *SOX* | *CCUK* | *ASXGCG* |
|---|---|---|---|---|---|---|
| *Governance Framework* | Yes | Marginal | ✓ | × | × | ✓ |
| *Shareholder Importance* | Yes | No | ✓ x 2 | × | ✓ | ✓ |
| *Disclosure & Transparency* | Yes | No | ✓ | ✓ | ✓ | ✓ x 2 |
| *Board's Responsibilities* | Yes | No | ✓ | ✓ | ✓ | ✓ |
| *Directors' Performance* | Yes | No | × | × | × | ✓ |
| *Remuneration* | Yes | No | × | × | ✓ | ✓ |
| *Auditor Independence* | Yes | No | ✓ | ✓ | ✓ | ✓ |
| *Conflicts of Interest* | Yes | No | × | ✓ | × | × |
| *Company Oversight Board* | Yes | No | × | ✓ | × | × |
| *Corporate Fraud* | Yes | Marginal | × | ✓ | × | × |
| *Penalties & Sentencing* | Yes | No | × | ✓ | × | × |
| *Ethical Decisions* | Yes | Yes | × | × | × | ✓ |
| *Risk Management* | Yes | Yes | × | × | × | ✓ |
| *Stakeholders* | Yes | Yes | ✓ | × | × | ✓ |

Table 3 shows a variety of combinations and that in itself shows the lack of consistency when designing and applying corporate governance initiatives. Specifically, all the principles are designed to protect absentee shareholders, and yet when applied in an SME context, it appears that only having a governance framework and corporate fraud would be marginally applicable, and only three principles are indicated to be of significance to SMEs, namely *ethical decisions*, *risk management* and a focus on the interests of *stakeholders.*

Arguably, from the analysis in Table 3, a case can be mounted to the effect that none of the other corporate governance mechanisms would have specific application in the SME context as a protection mechanism for SME shareholders, and that there is a lack of consistency when designing corporate governance regimes. Table 4 shows the potential applicability of guidelines to SMEs.

Table 4 Specific application of Guidelines to SMEs

| *International / National Guidelines* | *SME Business Applicability* |
|---|---|
| OECD | |
| Governance Framework | ✓ |
| Shareholders Rights | ✗ |
| Equitable Treatment of Shareholders | ✗ |
| Stakeholders | ✓ |
| Disclosure and Transparency | ✓ |
| Board Responsibilities | ✗ |
| SOX | |
| Public Company Oversight Board | ✗ |
| Auditor Independence | ✗ |
| Corporate Audit Responsibility | ✗ |
| Financial Disclosures | ✓ |
| Security Analyst Conflicts | ✗ |
| Corporate Fraud Accountability | ✗ |
| Penalties, Sentencing Guidelines | ✗ |
| CCUK | |
| Directors | ✗ |
| Remuneration | ✗ |
| Accountability and Audit | ✓✗ |
| Shareholder Relations | ✗ |
| *International / National Guidelines* | *SME Business Applicability* |
| ASXGCG | |
| Solid Foundations | ✓ |
| Board to Add Value | ✗ |
| Ethical Decision Making | ✓ |
| Integrity of Financial Reporting | ✓ |
| Timely and Balanced Disclosure | ✓ |
| Shareholders Rights | ✗ |
| Risk Management | ✓ |
| Enhanced Board Performance | ✗ |
| Remuneration | ✗ |
| Stakeholders | ✓ |

## 6. Results

Table 5 summarises the guidelines with potential application to SMEs. It reveals a limited application of the guidelines in the SME context, with the codes mainly advocating auditor independence, board responsibilities, remuneration, and shareholders rights. An obvious implication for SMEs is that they do not apply, and that the rule of thumb that what is applicable to large business is the same for small business is flawed.

Table 5 Applicable Guidelines for SME Governance

| | OECD | SOX | CCUK | ASXGCG |
|---|---|---|---|---|
| Governance Framework | ✓ | ✗ | ✗ | ✓ |
| Disclosure and Transparency | ✓ | ✓ | ✓ | ✓ |
| Stakeholders | ✓ | ✗ | ✗ | ✓ |
| Ethical Decision Making | ✗ | ✗ | ✗ | ✓ |
| Risk Management | ✗ | ✗ | ✗ | ✓ |

## 7. Discussion

### 7.1 Corporate Governance Framework

Referring to the definitions presented of corporate governance, and its importance to the running and the future of organisations, it is important to acknowledge Owens' (2004) framework approach to corporate governance, of encompassing rules, regulations, systems and processes. It is reasonable to assume that those dealing with SMEs would prefer to do so with one that worked within an explicit a good governance framework, than with one that failed to do so. Thus the framework approach being all-inclusive should be particularly important to SMEs as it does not dictate specific obligations, but takes a general approach, which for SMEs will include the acknowledgement of stakeholders, risk management and ethics.

### 7.2 Disclosure & Transparency

Although it can be applicable to SMEs, a focus on disclosure and transparency appears to be flawed as it is usually employed to decrease agency costs (Jensen and Meckling 1976), to mitigate the potentially adverse impact of a separation of ownership from control (Berle and Means 1932). As an SME will frequently display a characteristic where the owner is the manager, there does not appear to be a need to prove the performance of the entity through the preparation of financial statements, however financial information can still be used by management as an indicator of the relative efficiency of the allocation of scarce resources, and to enable strategic decisions to be made.

**7.3 Stakeholder Interests**

It has been argued that business is not just concerned with production of goods and services to profit shareholders, but has the welfare of a wider stakeholder class to consider. This appears to be particularly true for SMEs. Conti (2002 p.374), for example, states that a “stakeholder is a collective concept used to identify the interested parties in any organization”. SMEs by nurturing their relationship with stakeholders can create mutual co-operation and efficiencies throughout the supply chain. Freeman is generally credited with introducing the stakeholder theory or the theory of the firm (1984). That is, those firms exist for the purpose of serving stakeholder interests. Evan and Freeman state that (1993 p.102-3) “a stakeholder theory of the firm must redefine the purpose of the firm . . . the very purpose of the firm is in our view, to serve as a vehicle for coordinating stakeholder interests”.

On those grounds it is reasonable to expect that managers of the modern SME must satisfy a larger range of stakeholders than shareholders alone. The use of corporate governance as a management technique is crucial to its long term sustainability. The UK Hampel Report (1998 p.1) discussed stakeholders in that “directors are responsible for relations with stakeholders, but are accountable to the shareholders”. For SMEs where shareholders are the owners and the managers, a greater focus is on the cementing of relationships with stakeholders, the vital links in the business chain. In terms of corporate governance for SMEs, there appears to be an emphasis on the importance of strategic relationships with these stakeholders.

**7.4 Ethical Decision Making**

Ethics has always been an important issue for the modern corporation (Smith, 1776 and Spencer, 1862). Directors specifically have been targeted by the ASXCGC (2003) to make sure they exhibit high ethical standards. In relation to SMEs, *reputation* is of paramount importance, as not only does it dictate the value of the business in terms of Goodwill (AASB1013, 1996) it also allows the business to forge relationships with customers and trading partners. For SMEs, it would appear that ethics and hence reputation is part and parcel of their existence, it is vital to create new customers, attract good employees, create good relationships with suppliers and goodwill with the community.

**7.5 Risk Management**

Risk in terms of auditing can be inherent, control or detection, but on a broader scale is seen as an indicator of the going concern or future viability of an organisation. Risks faced by SMEs include economic downturn, increases in interest and exchange rates, changes in legislation, employee turnover and industry challenges. Risk management for SMEs appears to be a critical management issue to be monitored and addressed on a regular basis.

### 7.6 SME Specific Governance

In a report issued by the World Bank – *Corporate Governance: A Framework for Implementation* (Iskander and Chamlou, 2000) it made the point that there is no one-size-fits-all blueprint for corporate governance. This is reiterated by Standards Australia (HB401 - 2004) who was able to recognise specific corporate governance initiatives for the public sector, not-for-profit sector, universities and small business. They make reference to the specific characteristics small business demonstrate - such as the close control and operation by owners - and to corporate governance only on the issues of decision making, planning and business succession. The findings of this study can now assist SMEs to not only recognise the importance of corporate governance, but guide recommendations on the specific governance issues that apply in the SME governance context.

## 8. Implications

This study has found that not all corporate governance regimes apply in the same context for large businesses as opposed to small businesses. Large corporations are subject to more formal rules than SMEs, and this can be attributable mainly to their differences in characteristics. Studies done by Ghobadian and Gallear (1996) and Yusof and Aspinwall (2000), show that there are differences between large and SME business. By acknowledging these differences, why corporate governance regimes do not apply in some contexts for SMEs in terms of managerial implications, and why others do, is explicable.

The answer then to "***Are the current international corporate governance regimes applicable in the SME context" – is generally no***. Thus showing that not all corporate governance regimes are applicable to SMEs.

## 9. Conclusion

That the governance mechanisms appropriate, what is *good* for large business is by default also good for SME business is false. This study has shown that primarily due to size and other differing characteristics SMEs must tailor their corporate governance initiatives to meet their specific and in some instances unique needs. In particular, the prevailing agency issues relating to absentee shareholders, hired professional directors and management, the imposition of means to achieve independent audit and remuneration setting, are generally inapplicable in the SME context.

This study has shown the five elements of SME applicable corporate governance exhibited by the popular regimes ; the need to develop a corporate governance framework, the means to ensure disclosure and transparency, stakeholder wellbeing, risk management and ethical behaviour. Curiously, whereas the framework in which they might be set has the same necessary general characteristics as that for large enterprises, the initiatives for SME business are more specific than the literature suggests and has nurtured in the large business context. SME specific governance is an important but generally unmet initiative for SME businesses in an international context. For, whereas *one-size-fits-all* in respect of the appropriate corporate governance framework, *one-size-does-not-fit-all* in respect of the necessary specific operational mechanisms.

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