Corporate Governance in the Small and Medium Enterprises (SMEs) as Performance Enhancer

Conference Paper · May 2020

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Proceedings of
the 35th International Business Information Management Association Conference

(IBIMA)

1-2 April 2020
Seville, Spain

ISBN: 978-0-9998551-4-1

Education Excellence and Innovation Management:
A 2025 Vision to Sustain Economic Development during Global Challenges

Editor

Khalid S. Soliman

International Business Information Management Association (IBIMA)

Corporate Governance in The Small and Medium Enterprises (SMES) As Performance Enhancer

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Abstract

Although the number of Palestinian SMEs has been grown last few decades, they face a lot of challenges. The low performance compared to other counterparts around the world is the first of these challenges. Therefore, this paper aims to provide concise description of SMEs in Palestine with an analysis for the current challenges they face. Moreover, the study aims to explore the need of SMEs to embrace a corporate governance (CG) code to elevate their performance and the different advantages and disadvantages of the implementation of their practices. The study found that there is a wide believe that CG code introduces new strategic perspectives through the use of external directors who will add value over the improvement of entrepreneurial activities and increase the competitiveness of SMEs. This is particularly important, as a considerable portion of entrepreneurs in context of Palestine initiated business without a former technical experience. Further challenges such as funding constraint and managerial lack of proficiency in the sector of Palestinians SMEs could be coped with the use of a sound structure of CG in place. There is a wide body of knowledge supports the embracing of CG practices within SMEs at premature phase, in order to have a smooth progress when these SMEs grow in the market.

Keywords: SMEs, Corporate Governance, SMEs Performance; SMEs in Palestine.

Introduction

During last few decades, the corporate governance (thereafter; CG) became an interesting and debatable dominated policy agenda in the most of developed countries. It progressively heating its path to the top priorities of the policy schedule in many governments around the world. The financial crises (eg.1997 Asian crisis, and 2008 US crisis) resulted in the collapse of multinational corporations and impacted many other economies around the world, beyond the corporations themselves. This makes CG a catchphrase in the development debate among practitioners and academic researchers.

Emerging markets, of which Palestine is no exemption, are progressively accolade the concept of CG, as this concept has the ability to influence positively on the sustainable growth. It is believed that well CG breeds a confidence for an investor. Currently, companies are working on enhancing their CG practices in order to rise their values and promote the bottom line. CG is seen as followed structure to direct and run the affairs of the firms toward improving business operations and firm's accountability with the final aim of obtaining a long-run stockholders' value, while taking into the considerations the interests of all other stakeholders. In addition, CG delineates to the structure and strategies to be implemented in place to assure a suitable running of company bodies (Adonu, 2017). As argued by (Claessens, Djankov, Fan, & Lang, 2002) keeping a good CG framework could benefit the companies by increase access to funds, reduce costs of fund, promote good performance and provide more appropriate value for all of stakeholders.

The topic of CG has been a growing realm of management studies particularly among listed big companies. However, studies relate CG to SMEs gained substantial attention in the developed countries (Abor & Adjasi, 2007). SMEs around the world do not strictly comply with CG codes; nevertheless, such SMEs do believe that such CG codes should also been applied by them. Accordingly, the aim of this article is to provide concise description of SMEs in Palestine with an analysis for the current challenges they face. Moreover, the study aims to explore the need of SMEs to embrace a corporate governance (CG) code to elevate their performance and the different advantages and disadvantages of the implementation of their practices. The argument will be provided based on some reasoning of the benefits of adopting CG practices as opposed to some scholars who placed less importance of embracing CG practices for SMEs. Furthermore, the study will provide some insights on the lack of use of CG practices among SMEs.

Small and Medium Enterprises (SMEs)

The literature did not have an agreement over a certain definition for SMEs, as various authors provided various definitions (Bundaleska & Dimitrova, Makedonka Nikolovska, 2012). However, it is generally related to some criteria such as magnitude, number of employees, capital… etc. (Abor & Adjasi, 2007; Asunka, 2017). OECD defines SMEs as "non-subsidiary, independent firms which employ less than a given number of employees".

The number of employees can vary from a country to another. For instance, it is commonly known that the medium enterprises are those which employ less than 200 employees, however it is 250 in the European Union and 500 in US. Firms which employee less than these numbers fall under the category of "Small firms", while micro-enterprises employ a maximum of 5 to 10 workers.

A new definition for SMEs came into force in the European Union by the beginning of 2005, it takes the financial ceilings into consideration. Hence, SMEs are those which have number of employees between 50 and 249 with turnovers do not exceed EUR 50 million. With this new definition, the small enterprises are which have number of employees between 10 to 49 and with an annual turnover does not exceed EUR 10 million. Micro firms are defined with a number of employees of less than 10 and an annual turnover that does not exceed EUR 2 million. Alternatively, the classification can be done according to the balance sheet, as it should not exceed EUR 43 million EUR for medium size enterprises, EUR 10 million EUR for small size firms and EUR 2 million EUR for micro size enterprises (OECD).

Governments of many countries have undertaken steps to promote and support the establishment and the growth of SMEs, since these SMEs are the backbone of the economic development. SMEs sector is deemed to be the largest in terms of employing workers at some of the developed industrial economies (Carsamer, 2009). Small Businesses are evident in many sectors, such as in commerce, education, health, manufacturing and other service industries (Adonu, 2017).

A Glance about SMEs in Palestine

The Palestinian Monetary Authority defined Small Enterprises as those with less than 25 employees and with annual sales of less than USD 7 million (The Portland Trust, 2013).

A survey conducted on the Palestinian economy found that 97% of the firms are classified as SMEs and they currently employs 65% of the total workforce in Palestine. Two thirds of the sole proprietorship Palestinian enterprises are located in the West bank and the third are located in Gaza (PCBS, p.21). Above 85% of all establishments in Palestine are owned by sole individuals, which means that SMEs dominates the Palestinian economy (S. S. Sultan, 2014). In the West Bank, there are 88,4421 national establishments. In Gaza Strip, the number of these national operating establishments are 42,853 (PCBS, p.19). Only 137 enterprises in Palestine employ over than 100 workers, majority of them are located in West Bank (100 companies) and the other 37 are located in Gaza. The majority of SMEs in Palestine employ less than 9 employees (The Portland Trust, 2013). The entrepreneurship in Palestine is mainly initiated based on the individual or family savings with little support from the official agencies.

Similar to other economics, SMEs in Palestine play a vital role in the process of economic development, as they reduce the government burden on creating jobs and therefore reduce government expenditures. SMEs are considered the safety valve against political instability arises from deteriorating political conditions in the country. SMEs Establishment can be an efficient strategy to mitigate unemployment and reduce the government expenditure (Abuznaid & Doole, 1999, p.1).

The main incentive for Palestinian start-up business varies from one to another, as majority of them start their businesses motivated by their prior experiences and savings, other entrepreneurs start their businesses to find job and to invest savings (Sabri, 2008).

SMEs growth in Palestine is obstructed by a number of challenges, mainly are: limited funding chances; weakness of legal environment; tighten resources for expansion and lack of skillful employees. Moreover, it faces many challenges related to marketing aspects, such as: weakness of marketing capabilities and limited access to markets; weak distribution network; limited marketing polices and a high percent of inactive capacity as most of business companies have no brand names for their products. The Palestinian SMEs lack of ability competition in both local and international markets is another challenge they face, as they are not able to reduce their costs of production and enhance the products quality, whether it is commodities and services to meet favored requirements by customers. Finally, the majority of Palestinian SMEs are family firms which encounter conflicts in management (Sultan, 2014).

Family business is dominated in Palestine, as 96% of Palestinian SMEs are considered family firms, Over 70% of them are located in the west bank. Varying interests among family members can complicate the management process through arise tension which often leads to disputes and management operation could tangle with the family relationships which may cause inefficiency of management (Abuznaid, 2014). For Palestinian family businesses, the main sources of insider disputes are distributing profit, withdrawing profits without former agreement and differences in managing style. These conflicts often cause to liquidation or may to dividing the firm among family members (Nidal, 2010).

In Palestine, family firms struggle to perform well compared to non-family firms. Further, Palestinian family companies are centralized and their owners of to keep the affairs in privacy, which cause a lack of sharing information about their businesses, this leads to slowing down the responses of SMEs towards the threats and opportunities in the external environment. Moreover, family businesses discourage the possibility of staff promotion in the firms. Therefore, such practices lead to the loss of chance to make a better informed decisions or even contributing in making a creative idea which could affect development of business (S. Sultan, de Waal, & Goedegebuure, 2017). The lack of experience is another challenge face Palestinian family businesses, as 26% of them start their own business without former technical experience (Abuznaid, 2014). Most importantly, the Israeli occupation policies and procedures restrict the movement of individuals and raw material in or out of Palestine even among Palestinian cities (Atyani & Sarah, 2009; Nidal, 2010). This further restricts the growth of such sector and limits its activities significantly.

Corporate Governance

The CG has been initiated by number of the international organizations. In 1999, the OECD has developed the principles of CG to support the framework of organization. Since that date, those principles shaped the basis of the CG in both OECD and non-OECD states alike. These principles have been adopted as one of the 12 key criterion for sound financial system by the Financial Stability Forum (OECD, 2004). CG is critically important matter in the services industry. Scholars defined the CG from different perspectives. Table no. 1 shows some of these definitions.

Table 1: definitions for CG

Definition	Author (s)
"Corporate governance is concerned with ways of bringing the interests (of investors and managers) into line and ensuring that firms are run for the benefit of investors".	Mayer,1997
"CG is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability"	Deakin and Hughes,1997
"CG is the process and structure used to direct and manage the business affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders"	Keasey et al., 1997

Thus, CG is all about that firm is managed well and in line of the interest of stockholders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2007; Mayer, 1997). The rapid progress of CG and its' structures indicate how important is such concept to the business entities, governments and communities as well (Ho, 2005). Hence, the relationship between CG and firms performance is an interested topic for investigation (Brennan & Solomon, 2008). Accordingly, well devised CG practices are essential for companies to access funds from the stock market and to maximize its market value. These practices assist firms to reduce inefficiencies and at the same time boost firms' profits.

CG and the internal operations of the company

CG could affect a wide range of internal operations of the company, which are strategic direction; financial anticipations; transparency and stockholder's activism. Strategic direction determines the company's long-run direction. CG requires the placement of board members which should bring in skilled members into the enterprise which foster the entrepreneurial direction of the company. Furthermore, appointing such members in the company might cause in more attention to be given to the research & development and the innovation. The choice of governance mechanisms actually does affect firms' ability to change their strategy (Brunninge, Nordqvist, & Wiklund, 2007).

Managers prefer projects that have immediate results, as their performance is subjected to how well these projects perform. This could result on some impeding on the entrepreneurial success. On another hand, some managers do not share the profit with other employees upon the success of selected project, this may reflects an environment whereby corporate governance is not well practiced (Abor & Adjasi, 2007).

The transparency has been touched at the initiation of CG and through its' reform as well. The transparency has been assured through the followings: i) There are clear guidelines for disclosure of all activities of the board of directors; ii) The audit committee at levels of external and internal is a requirement for sound CG (Brennan & Solomon, 2008) and iii) all CG procedures sought to control managers' misbehaviors and frauds as well as regule the activities of over keen auditors to control in value creating activities.

CG and SMEs

CG has been traditionally related to larger firms where there is probability of having agency conflicts. These conflicts arise as a consequence of separation of ownership and the management of firms, which lead to have different interests among parties. In other words, the agency problems arise within company if there is a conflict between stockholders and the management (Hart, 1995). This may refer that CG is not applicable to SMEs where there is less probability of occurrence of such agency conflicts. SMEs are, usually, developed by only a single person who is the owner and the manager at the same time. SMEs incline to have a less pronounced separation of ownership and managing compared to big enterprises (Adonu, 2017). As they have few staff who are, in generally, relatives to the owner. Hence, there is almost non-existence of the separation between the ownership and management, this eliminates the need for the CG in the SMEs operations.

The non-need for the CG by SMEs can be shown again when there is no accountability for SMEs by the public as these firms do not rely on public funds. Most of the single proprietorship ventures may not need to comply with standards of the disclosure. Moreover, there is no agency conflict in SMEs as a result of: i) the absence of the wealth maximization goal for this type of ventures and ii) there is ignorance for the results of firm's activities, these results usually lead to conflict between different parties of the venture. Thence, conflicts do not exist and therefore no need for CG to resolve such issues.

Despite such arguments, there is an international interest for the implementation of CG in SMEs as the CG guidelines are applicable for SMEs. "The ongoing tendency toward improving board functions within publicly listed firms will extend to SMEs by mimicry and institutional pressures" (Corbetta & Salvato, 2004). There are lots of areas where CG could be applied in SMEs. For example, board size and characteristics of board members can be an area of inquiry. In a sense of how does the board size and board member characteristics can impact the performance of the enterprise and the extent of the difference between SME and an established corporation. Other areas of inquiries can include the effect of CEO duality of SMEs and family ownership on SMEs financial performance (Abor & Adjasi, 2007).

Benefits of CG for SMEs

Some scholars claimed that the merits of CG may entice SMEs to adopt, particularly growing entrepreneurial companies which have the prospects growth and trend to extend beyond their states of survival (Abor & Adjasi, 2007; Clarke & Klettner, 2014). The advantages of CG to listed companies could be implemented to SMEs as well. Simply, the implementation of CG practices can help SMEs to grow rapidly. The growth of entrepreneurial companies requires access to necessary resources which can be obtained via the existence of effective board of directors that characterized by high independence as in the situation of listed companies (Adams, Hermalin, & Weisbach., 2010).

Chen (2008) analysed the impact of CG on listed companies, he pointed out that good strategies impact the firm performance and external board members confront policies and strategies by managers of firms. Therefore, the implementation of the same on SMEs may enable to have such members and lead to take best decisions for the firm.

As referred earlier, obtaining funds is one of the major hindrance face Palestinian SME sector to grow. Hence, the incorporation of CG into SMEs sector could highly minimize such restriction, as the external board members may come up with ideas to entice funds. Further, they may foster the enterprise's creativity and innovation by provide suggestions during the process of decision-making. A sever example of this is "Small Enterprise Agency" in Japan which achieved great growth via the utilization of non-executive directors more actively than big companies (Abor & Adjasi, 2007). On another hand, the growth of the entrepreneurial companies requires implementation of good governance practices and professional managers. This may starts by the separation of ownership and management (Fleming, Heaney, & McCosker, 2005).

To have good performance, motivations would be offered to professional directors to encourage them to do their best. Additionally, to have good performance a governance unit must be evident and distinguished. For example, internal audit unit and accounting control unit will have been laid in place to assist in evaluating the performance of such directors. The absence of such feature resulted in dreadful implications on SMEs in Palestine, where SMEs are managed by less qualified people, mostly family members and a single proprietor. Hence, the implementation of CG is a constitute room for the composition of the board that encompass outside directors who are not necessarily related to the owners and therefore deduce more independent sound practices of managing the firm and gaining profits (Adams et al., 2010).

In Palestine, SMEs growth is a tremendous challenge. Many reasons can be provided, but poor managerial skills by entrepreneurs is evident. In this case, the CG structure introduced within SMEs business process could tackle this problem by introduce more expertise and further enhance the internal procedure of the business. Introducing CG structure will free up proprietor operator from working duties, hence the separation between management and ownership control could be possible in the SMEs. CG paves the path for potential future growth. Sometimes company sought to obtain new finance, this oblige much work to be done pre confidently going to the stock market and requires some time for the SME to be completely listed in the stock market. During this time, the CG adoption and implementation become critical for SMEs to enhance their potential growth (Adonu, 2017). Thus, harmonious trajectory record of sound governance will highly help when that time comes. Thence, the implementation of CG structure at premature phase will lead to obtain experience and cultivate discipline in the management of the company. This is significant, as the external bodies such as the stock market authority and other lending institutes need to assure good managing practices are followed by SMEs. CG permits such companies to smoothly been prepared for future initial public offering (IPOs). For instance, in Palestine, early implementation of CG would prepare SMEs sufficiently even pre they get listed in Palestine Exchange Stock Market. The presence of a board of directors for instance will prompt fast growth strategies in SMEs for quick profit; at some point this will require the company to seek for more finance, thus, going public will be of added value to them. Therefore, the transmission from a small to medium and eventually to big firms will be smoothly supported through an efficient CG which ensure active company control system.

In same token, sound CG practices help SMEs to enhance their chances of access finance from both financial institutions and other angel investors. This is an expected result of proper book keeping, good accounting practices and the disclosure of information which convey the trust among all the relevant stakeholders. In the same line, SMEs will have a healthier growth and be obliged to firm’s effectiveness because of the existence outside supervisory parties. In addition, applying the sound CG principles minimizes the problems related to asymmetric information and makes such firms low in risk for investing.

Disadvantages of CG for SMEs

Although the benefits which SMEs can be gained on the implementation of CG practices, its’ disadvantages should be taken into consideration as well. Implementation of the CG will imply extra auditing rules, reward and candidacy committees. Furthermore, the implementation of CG will require an additional recruitment of directors as it will add to the management complexity of SMEs at an early stage. The recruitment of additional directors will require a complex reward system and appointment of external directors based on some regulation in the country. accordingly, the implementation of CG into operations of SMEs will rise operational costs in the form of high cost of start-up which may dissuade many from initiating business. This issue can be solved by the policy-makers through providing their services as volunteers for SMEs, especially in the start-up stage.

It is worth here to refer to the perspective of the stakeholder theory on CG. The proponents of this theory postulate that stockholders are only a part of the significant stakeholder group. Thus, CG tools must consider and integrate all of other stakeholders. As this may assist in enhancing CG through promoting stakeholders’ interests with the firm's interests. Furthermore, such integration can assist to boost CG tools. In fact, although it is argued that all stakeholders may have a common interest in SMEs business. However, such common interest does not necessarily result in a unified owner’s interest. As individuals, there is a likelihood of free-ride problem to occur or individuals evade work efforts despite the joint interest (Heath & Norman, 2004; Norman, 2004).

Conclusion

The significance of the CG cannot be overlooked since it forms the organizational climate for the inside activities of the firm. CG in Palestine can highly help the SMEs sector through implanting sound managing practices, powerful insider auditing committee and largely chance for growth. Applying CG in Palestinian SMEs can brings new strategic sights by outside independent directors which may improve entrepreneurship and competitiveness of Palestinian SMEs. Applying principles of CG properly in entrepreneurial companies cannot form a threat of value creation. Thus, it is significant for companies to have commitments on value creation.

Sound governance tools in SMEs are probably to cause boards to put much needed pressure on performance improvement via assuring that the interests of the company are served. In the situation of SMEs, members of board bring into company new experiences and knowledge on funding choices obtainable and strategies to source such funds, therefore it can deal with the credit handcuff issues as well. Sometimes, firm who are willing to have external finance realize that a lot of effort needs to be done pre confidently going to the financial market. Recording history of sound governance will highly help it for that. SMEs need to take into consideration the role of all stakeholders by a bottom-up approach where, for instance, the perspectives of unions (e.g. in the situation of employees) are explicitly put in the meetings of board. Also, it should be pointed out that sound governance maybe does not guarantee firm success. However, non-well governance maybe is an indicative of a firm non-success. More significantly, rising the trust of current owners and possible new ones is a worth aim.

Limitation, implications and future studies

The limitations and of the study is the debate fundamentally concentrate on CG in the context of Palestinian SMEs. Therefore, the current study offers conceptual views on the application of CG among SMEs particularly in Palestine. Thus, future studies could empirically examine the impact of CG on these issues whether in the context of Palestine or in other business environment, in order to provide evidence about how could the implementation of sound CG reduce funding constraint and managerial lack of proficiency and enhance management practices within SMEs.

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