On Governance and Agency Issues in Small Firms

Clifford W Smith
On Governance and Agency Issues in Small Firms

by Clifford W. Smith Jr.

The study of small businesses has received limited attention by financial economists. This volume makes important strides in redressing this oversight. I believe that small businesses offer important research opportunities but also present substantial challenges. In this note, I discuss aspects of each.

Small businesses are intrinsically interesting and important. They account for almost half the overall employment in the United States; moreover, over the last decade this sector has been responsible for two-thirds of new jobs. The juxtaposition of these two statistics highlights the important role that these firms play in terms of the dynamics of the larger economy. They are responsible for a disproportionate number of innovations—both in terms of new products and new processes. Someone with an innovative idea can capitalize on it by starting a small business to exploit the idea. And the more robust this sector, the larger the pool of experiments being undertaken and the more rapid the overall rate of innovation within the economy.

Small businesses provide an important set of research opportunities for financial economists. It is useful to think of identifying those factors that are important determinants of corporate policy decisions as running a regression. The precision of economists’ estimate of the impact of a factor such as operating risk on a decision like target leverage depends on the observed variation in the right-hand-side variable.

This sector includes extreme examples of factors that are common to a broad range of companies. An obvious example is firm size. Although at some level, size is endogenous, researchers regularly treat it as predetermined; it frequently is important in explaining leverage, risk management, payout, board structure, and compensation policy decisions. This sector also includes firms that have high operating risk, that own assets that are quite firm specific, and that have low transparency.

Small businesses frequently are closely held. By eschewing public capital markets, entrepreneurs maintain control and avoid regulatory burdens. These firms thus offer extreme observations on ownership concentration, and on the overlap between ownership and man-

Clifford W. Smith Jr. is the Louise and Henry Epstein Professor of Business Administration and professor of finance and economics in the William E. Simon Graduate School of Business Administration at the University of Rochester.

Address correspondence to: Clifford W. Smith, CS-3202C Carol Simon Hall, William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, NY 14627-0107. Tel: (585) 275-3217. E-mail: smith@simon.rochester.edu.

176 JOURNAL OF SMALL BUSINESS MANAGEMENT
agement. As a result, these firms tend to exploit leasing and risk-management opportunities more extensively than otherwise similar public firms.

Finally, this sector includes richer variation in the choice of organizational form—corporation, limited liability corporations, partnerships—than is reflected in the firm populations that are more regularly studied. This variation provides potentially useful texture in our understanding of important firm policy choices. For all these reasons, data from small businesses substantially expand our range of observations and thus the power of our tests.

Voordeckers, Van Gils, and Van den Heuvel (2007) offer a good example; they examine data that differs materially from that typically reported. They analyze 211 small and medium-sized Belgian firms. They examine the effects of firm size, firm age, life-cycle stage, and various characteristics of the CEOs and their families, in explaining the firms’ board composition.

Because this analysis employs Belgian data, it has the potential to make substantial contributions to our understanding of the role that the business environment plays in governance systems. To identify the impact of the legal system or the tax code, one must be able to observe decisions across legal and tax environments. The U.S. legal system evolved from the British common law; the Belgian legal system evolved from the Napoleonic Code. Tax law also plays a potentially important role in explaining observed board composition. For instance, in a U.S. family-owned corporation, family members would receive two checks—compensation as a return to labor services plus dividends as a return to capital ownership. Before the recent change in the taxation of dividends, both checks would be treated as ordinary income to the individuals but only compensation would be deductible to the corporation. Thus a tax bias exists in favor of calling payments “compensation” as opposed to “dividends.” Although this might be tax efficient, if some members were not employees, they would receive too little return on their capital. Because only outside directors receive board fees, by naming these individuals to the board, these equity issues across family members can be resolved. Thus, board composition in family-owned firms potentially is influenced by tax considerations.

One of the major challenges facing researchers interested in studying small businesses is the limitation on data availability. Because they typically are not public firms, which would be subject to Securities and Exchange Commission reporting requirements, databases like COMPSTAT rarely include such observations. Moreover, because small businesses generally borrow from private lenders, much of their supply of debt capital is confidential. Thus, researchers frequently must assemble their data sets or employ data that were collected for some other purpose.

Danielson and Scott (2007) examine data from a survey of 792 CEOs administered by the National Association of Independent Businesses. The survey asks business owners to identify their most important business concern. They focus on the 150 respondents who report underinvestment and the 181 who report overinvestment. They find that the underinvestment firms are growing and have concentrated ownership. The overinvestment firms have less concentrated ownership and control structures. These results are consistent with basic finance theory. Myers (1977) suggests that firms with more growth opportunities should have more pronounced underinvestment problems. Moreover, Jensen (1986) suggests that free cash flow—or overinvestment—problems arise from the separation of ownership and control.

However, I still have reservations about the methods employed by Danielson and Scott (2007). First, the analysis
of the survey data presumes that what we think we are asking about "under-investment" and "overinvestment" is the same as what respondents think we are asking. I am not completely convinced that this language means the same thing to both groups.

Finally, policy choices in both large and small firms are interdependent. For example, the firm's corporate strategy implies that value is a particular mixture of growth opportunities and assets in place. Firms with more growth options will choose higher target leverage, more short-term debt, more convertible debt, less leasing, and lower payouts than firms with more assets in place. Thus, the underinvestment and overinvestment problems that Danielson and Scott (2007) examine are partly endogenous—Jensen (1986) emphasizes that leverage is a powerful mechanism in controlling free cash flow problems. Unfortunately, the authors do not have access to that type of financial data.

Even if data on all the corporate policy choices were available, the theory is not so well developed that the structural parameters using simultaneous equation methods could be identified. To identify the various equations, we must have independent (or at least predetermined) variables that belong in one equation, but not in the others. In fact, this estimation problem is more severe in small businesses than in large public corporations. In a large public firm one could argue that corporate strategy is set by the CEO and the board. For instance, making financial policy decisions, the CEO could take strategy as predetermined. However, in a small business, the entrepreneur plays a more central role in all these policy choices and thus they are more fundamentally joint decisions.

References