Melbourne Business School

From the Selected Works of Graeme Cocks

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Where Small Business hits the Big Times: Good Governance is More Affordable Than Ever

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ABSTRACT

Small and mid-size firms more often than not fill board seats with executive directors, mostly representing founders and operators of the business. While we observe a clear trend towards the addition of independent directors, the perceptions of cost and lack of contribution appear to be hurdles for smaller business when it comes to the strengthening of their boards. Based on four consecutive annual reviews of governance in NZ, with a special emphasis on SMEs, we suggest that shareholders and senior managers of SMEs are beginning to understand that external directors do add value - and are a lot less expensive than previously thought.

While Fama and Jensen (1983) argued that separation of ownership and control leads to agency issues, clearly perceived by many owner/operators as a dilution of their control over the firm, we know that independent directors are important for an effective balance of a board (Rezaee, 2009), and thus we attempt to describe practically relevant factors that support the inclusion of outside directors on SME boards.

Our research shows that current SME boards lack key skills expected from board members and that the majority of director roles are filled through a tight circle of insiders, mostly existing board members and management. We doubt that these friends of friends are as inquisitive, asking insistent questions, as required (Newcomb 2006). We also demonstrate that compensation, an often cited hurdle to appoint external directors, is not a key motivation for new board members. In fact, compensation ranks among the least-important motivators when directors contemplate new board invitations.

We conclude that there is clear evidence that SME boards need in infusion of stronger skills, and that this will be a less costly exercise than presumed by many. We remain cautious, however, over the emotive issues when outside directors are given voting rights in owner-operated and family-held firms, and suggest that more education is needed for existing shareholders and SME executives to better understand the value proposition for external directors.
BACKGROUND

Small and mid-size firms more often than not fill board seats with internal/executive directors, mostly representing founders, operators and large shareholders of the business. While we observe a clear trend towards the interest of SMEs to consider the addition of independent directors, the perceptions of cost and lack of immediate contribution appear to be hurdles for smaller business when it comes to the strengthening of their boards. Often thought of as an expensive proposition, more than 40% of SMEs surveyed indicate they plan to add at least 1 independent director in the next two years. Extrapolated over the population of New Zealand firms, this would indicate an avalanche of independent director cascading onto boards of SMEs. Coulson-Thomas (2007) in his survey of the board of directors found that Boards per se appear to contribute little of significance to the business development of almost all the SMEs visited, and this backdrop indicates that New Zealand owners and management appear to see some value in independent directors – and even if it would be just cheaper to add external directors than to recruit the same individuals as consultants. --- In Coulson-Thomas’ work, hardly any of the companies had a working board in the sense of a group that “met regularly, worked through a formal agenda, addressed strategic as opposed to operational issues, took minutes of their proceedings and followed up their decisions.” He also found that that few companies employed non-executive directors and they were often thought of as “passengers” who would get in the way or, worse, try to prevent them from doing what they thought was ‘right’ for ‘growing the company’.” Do external directors then add value to SME boards and contribute positively to the companies’ performance?

While most of the debate in the literature has focused on the necessity of having formal boards for listed companies, non-listed companies seem to have missed out on this limelight and thus operate in the twilight zone of absence of formal regulation but keen interest of shareholders to be informed of governance processes. These firms are mostly “closely held companies whose shares, unlike those of publicly held companies, do not trade freely in impersonal markets, either because the shares are held by a small number of persons or because they are subject to restrictions that limit their transferability” (OECD, 2006). There can be different types of non-listed companies such as family owned companies, state-owned companies,
group owned companies, private investor owned companies, joint ventures and mass
privatised companies. New Zealand has a large share of family-owned agricultural
firms that squarely fit into this category of businesses with options to either create a
solid governance process – or to opt not to. With nearly 25% of NZ shareholders
reporting to us that they are “not well” informed about the governance processes of
their SMEs, there appears to be a gap between the expectation of governance
transparency by shareholders and the companies’ performance.

The need for strong boards has been recognised in the literature, particularly
pointing towards the need for independent/non-executive directors. It needs to be
mentioned here that shareholders are a dominating influence in such companies and
we thus wonder how effectively they discharge their powerful roles. Teksten, Moser
& Elbert (2005) noted that although considerable work exists on the need for board in
large publicly traded companies, there are not many studies on the need for boards in
small privately held non-listed companies. The board objectives can ‘vary from
fulfilling the legal requirements of a corporation to establishing a sophisticated
committee system to help the board direct a firm’ (Ford, 1992).

Some of the reasons as foundations for developing more effective board
governance are management continuity; specialised expertise; innovation; crisis
management; and arbitration. The board can play a useful role in the company if the
board objectives are matched with that of the company and the skills and abilities of
the directors are used in the development of company strategies. Also as Ford (1992)
suggested, the role of the board in a small company will vary with the life cycle of the
company. Thus its role will be different in start up stage from what it was in the
embryonic/seed stage. The different stages in the life of the company which Ford
(1992) identifies are: embryonic/seed stage; start up; early growth; rapid growth;
maturity; and stage of instability. While in the initial embryonic/seed stage the
emphasis is on ‘idea generation, learning, research, interest, and support building’, in
the start-up stage “an experienced team of board members could greatly assist in this
organizational stage as the company acquires the initial resources of personnel and
assets” (Teksten et al. 2005). Thus the role of the board of directors in small company
is crucial and dynamic as it keeps evolving with the different stages of the
development and maturity of the company. The objectives of the company and the
role of board thus keeps changing and the skill set and experience of the board should also evolve and move along with the company’s changing objectives. We raise the issue that the majority of directors responding to us indicate that the only area in which their competence is largely “very good” is in ‘commitment’ while self-reported competence declines in all other functional areas of governance. This then alerts us to the likelihood that the ‘use by’ date of directors might need extensions by upskilling in specific areas.

In the UK, studies have indicated that it is not the lack of candidates wanting to be appointed as non-executive director, but rather a lack in demand for such candidates. This is somewhat supported by the fact that thousands of willing directors are listed on CCMAU’s data base, on www.finddirectors.com and with various registers at the Institute of Directors, the Ministry of Women Affairs in New Zealand and the Auckland City Council, while the actual appointment of directors from these lists is negligible.

SMEs contribute significantly to the total output of the country and immensely contribute to generation of jobs and wealth creation. Considering their crucial place in the New Zealand economy, their functioning and governance has also been subjected to much attention. The literature recognises the usefulness and relevance of well functioning governance in SMEs as it leads to value addition to the firm, improved company structures and superior financial outcomes. Effective board contributions are also essential in the current global economic environment and will assist the SMEs in their ‘internationalization’ and acquiring knowledge based resources (Zahra, Neubauim & Naldi, 2007). Zahra et al. also found that the positive link between good governance and globalisation of these companies and acquisition is further enhanced and cushioned by the presence of outside and independent board directors.

The role of the Board in the literature has been identified as that of service, strategy, control and monitoring. Agency theory is widely regarded as the basis of control or compliance role as it emphasises principal-agent problem and the role of the Board is to solve this problem in the best interests of the shareholders. The debate on the role of the board in SMEs is not new and in fact can be dated as early as 1948 when Mace (1948) outlined the advisory and counseling role of the Boards. We have
found initial indications in our data that prospective directors consider board appointments are platforms to ‘do good’ rather than to serve as legal agents for shareholders, and thus we reflect that more than ‘agency theory’ binds directors into their role at SME boards.

Van den Heuvel, Van Gils, & Voordeckers (2006) provide a useful review of the literature on the role of boards in SMEs and family businesses. Based on their survey of 286 firms in Belgium they report that control and service are the two most well acknowledged roles played by the Boards. Zahra et al (2007) observe that the strategy and enterprising role of the Board comprising both outside and inside directors is very important as outside directors bring their unique experiences, skills and perspectives and complement the existing skill set of the Board. The innovative and strategy formulation has been emphasised by a number of studies as the research has shown that the presence of outside directors on the Board leads to ‘positive tensions and instills new ideas and ways of doing business’ (Zahra et al).

The board of directors have been described as the ‘apex of the firm’s decision control system’ (Fama & Jensen, 1983), but Brunninge, Nordquist, Wiklund J. (2007) observe that in reality the SMEs which are often family run businesses are tightly controlled and monitored by the owners and inside directors. We thus wonder how much of frustrating mis-match might occur when directors join with the motivation to contribute their significant expertise to ‘doing good’, only to be subjected to the role of fifth-wheel on a corporate vehicle that is tightly steered by insiders. Outside directors in such companies play a very limited monitoring and compliance role and may very well be included more for window-dressing than actual contributions. Encouragingly, many SMEs use outside directors for the strategy development role. It is the strategic/resource based role which is more crucial for the SMEs, and the outside directors “not tied to the day-to-day operations of the firm --- are likely to think more freely concerning the strategic alternatives open to the firm” (Brunninge et al. 2007).

In his paper on ‘where to find the non-executive’ Cree (2003) points out that instead of appointing high profile ‘big name’ executives, the company should look for the competencies, skills and caliber of the person. This supports our findings that
there is a demand for independent directors with a specific skill set, namely successful business experience with a global component. The director qualities required foremost among the non-executive board members overseas are “business and board experience, network of contacts, independence of thought, ability to express and communicate, and tact” (http://www.gowboard.com/pdfs/HiggsReport.pdf).

Chambers (2005) asks two related questions: what is the effect of the non-executive director and what makes the non-executive board director effective. The two questions although appear different are indeed related to each other. He further adds “Assuming there is the potential to add value to the company it will not happen without adequate time commitment, thorough preparation for meetings, recent and relevant experience, an inquiring and independent mind and, not least, team working qualities”.

Malizia (2008) suggests that in the hunt for board directors small businesses should “look for leaders who can “roll up their sleeves to run your small company” in other words, a hands-on approach; high profile executives of large companies as they have good knowledge of processes. We contrast that with most of our survey respondents who wish their boards to spend LESS time on operational matters and more on strategic planning matters and guidance for management. Overall, the Board to perform effectively should have the seven R's, that is, right mindset; right role; right work; right people; right agenda; right information; and right culture (Nadler, 2004).

The sources from which the non-executives can be drawn upon are personal contacts and recommendations from people such as lawyers, accountants, or bank manager. Venture capitalists that financially back the company, to protect their own investments and also to support fresh ideas, are also a source of non-executive directors’ pool. Networking, such as business organizations, is another crucial source for non-executive search. Carayol (as quoted in Cree, 2003) emphasises that “to find new faces, we’ve got to look in new places. It is no surprise that using the old boys’ network turns up old boys.” We contribute the concern that nearly 60% of New Zealand directors are recruited from senior management and existing directors and
thus likely perpetuate a cycle of similarity where persons known and thus comfortable, are added to boards with the likely expectation to fit in easily.

In suggesting the approach to consider senior managers as possible directors in other firms, Carayol adds that “most people are flattered to be asked to be a non-executive director, regardless of the company. And even if someone can’t help you, they may be able to put you in touch with someone more suitable” (as quoted in Cree, 2003). This suggests to us that a large pool of competent operators might be available to step up to board performance, and we note that specific director training might be required to assist these executives to transition from an operational role into a governance/leadership position.

The transition from an owner operated/controlled firm to power sharing with a board may not be a smooth one and could involve different issues including succession issues. In a first such study Schnatterly and Johnson (2007) recognised the possibility of the position of CEO being taken over by the outside directors, and other issues which could emerge are the reduction in control by the inside directors and owners through dilution of authority. The board directors with their expertise, experience, and mature outlook should probe, challenge and offer recommendations in an atmosphere that is supportive rather than adversarial. This balancing act can exist only among mature people who are willing to be respectful and considerate, and who subordinate their sensitivities to the good of the company. This means that the CEO must terminate the aura of secrecy common to many privately owned companies and be candid with the board. Most, if not all, of the skeletons must come out of the closet (http://pervinfamilybusiness.com/library/articles/creating-board-directors.asp).

A useful tool to analyse the transition issues (or perhaps crisis issues) from being owner-operated/controlled firm to power-sharing with a board/board chair is Greiner’s Curve. Greiner’s Growth Model describes phases that organizations go through as they grow. Each growth phase is made up of a period of relatively stable growth, followed by a "crisis" when major organizational change is needed if the company is to carry on growing

http://www.mindtools.com/pages/article/newLDR_87.htm
The curve, an upward sloping one, was first proposed by Larry E. Greiner in 1972 and was originally comprised of five stages. It was later extended to six stages (see Greiner, 1998). The six stages are: Phase 1 - Growth through Creativity; Phase 2: Growth through Direction; Phase 3 - Growth through Delegation; Phase 4- Growth through Coordination;  Phase 4- Growth through Coordination; Phase 5 – Growth through Collaboration and Phase 6 – Growth through Extra Organizational Solutions that is mergers, outsourcing, networks etc. In each stage the company goes through crisis and thereafter moves on to the next stage on the growth path. The transition from owner-operated/controlled firm to power-sharing with a board/board takes place when the company is moving along the first three stages of Greiner’s growth model. It is during these stages that the company which initially had started off with few employees or perhaps only the family members, undergoes leadership, autonomy and control crisis. The Board herein plays a crucial role in separating the ownership and control and through their unbiased and neutral behaviour charter the company’s growth in new directions higher up on the Greiner curve. We recognize that this involvement by outside directors can cause concerns by the insiders over the possible power and control that is surrendered to directors external to owner families or operators.

It is generally assumed that the agency model of corporate governance applies to all entities with slight modifications, but the requirements of governance in SMEs are not the same as those of large publicly listed corporations, and we believe there is the clear emergence of ‘commitment drivers’ that go far beyond agency theory in depth. Clarke (2006) in this connection observed: “The problem for SMEs is that agency theory, whilst acutely relevant for large firms, is largely otiose for them. This arises directly from their architectural premise: the less-than separate notion of managers from owners. The problem with agency theory and, indeed, with other corporate governance modeling devices such as moral hazard theory and remuneration policy which seeks to better align the two disparate groups, is that they hold very little traction for SMEs.”

A separate model of governance which is sensitive to the firm size, has been proposed in this context. As the principal-agent problem is more prevalent and applicable for large firms rather for small ones, Clarke (2006) suggests that a two step
governance, one for large firms and another for SMEs, may be more appropriate. He further argues that “This binary divide should provide opportunities for simple, principle based governance for SMEs that can ‘weave’ its way up to large firms, rather than a continuation of the trickle down approach from large firms to SMEs”.

Gabrielsson & Huse (2005) on the basis 52 empirical studies of outside directors in SMEs showed that different theories such as agency theory, resource based view of the firm, and resource dependence theory can be applied to understand the roles played by outside directors can play in family firms, venture capital-backed firms and other SMEs. They further argued that that there is a “need to have a conscious and balanced use of theories for understanding the role and contribution of “outside” directors in SMEs” and one size fits-all approach cannot work in case of companies. Yacuzzi (2005) while pointing out the different characteristics and issues related to SMEs and differences between small and large enterprises noted that Resources –based theory which takes into account firm’s internal environment is more relevant in case of SMEs.
References


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