Guidance for Boards

GOVERNANCE CHALLENGES FACING SMEs

Small and Medium Enterprises face a set of unique governance challenges. The first step to overcoming them is to know what they are and to understand the benefits good governance can bring.

1 CPD hour

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INTRODUCTION

Globally, it is widely recognised that the SME sector is the true engine of economic growth and job creation. According to the World Bank, SMEs account for 90% of businesses worldwide and provide more than 50% of employment. Formal SMEs contribute up to 40% of gross domestic product in emerging economies.[1]

However, the picture is somewhat different in South Africa. Based on its research, the Small Business Institute says that 95.8% of the economy is made up of small and medium-sized enterprises, but they only account for 28% of jobs.[2] This is far lower than the global average of 50%, and significantly lags the target of 90% by 2030 set in the National Development Plan.

Even more worryingly, 70% of emerging small businesses fail within the first two years, according to the *2018 National Small Business Survey,* conducted on behalf of the National Small Business Council.[3]

In short, South African SMEs are not living up to their potential as creators of wealth and jobs. One of the factors hampering SMEs could be the challenges they face when it comes to implementing governance. Aside from the very real challenges SMEs face when it comes to governance, it must also be admitted that many of them fail to give the subject much thought because they do not see its value, or how it applies to them. Many may in fact see it as yet another compliance burden, adding to an already large burden of red tape.

Before looking at what the governance challenges are, it is necessary to first look at what governance is, and what benefits SMEs can gain from paying attention to it from the get-go. To quote from King IV's Supplement for SMEs:

> “*Good corporate governance contributes to the success of an SME, as it enhances the functioning of its leadership structures and helps the governing body to govern in such a way that the SME meets its strategic objectives.*
>
> *SMEs typically grow from the investment of energy, passion and resources by founding members over time, sometimes over decades and generations. Such SMEs eventually become a family partnership, consortium, syndicate or even company owned by a number of outside shareholders. The risk is for the governance structures and processes not to evolve and mature as the company does. Corporate governance facilitates stable and sustainable development and the ability to leverage opportunities. It is therefore important for SMEs to ensure that a foundation of good governance is established from the beginning, so that it is entrenched in the way the business is conducted.”*

[1] World Bank, “Small and medium enterprises (SMEs) finance”, available at https://www.worldbank.org/en/topic/smefinance.
[2] Small Business Institute, “The number of formal micro, small & medium businesses in South Africa Preliminary findings of stage 1 of the Baseline Study of Small Businesses in South Africa”, available at https://www.smallbusinessinstitute.co.za/wp-content/uploads/2018/10/SBIbaselineAlert1final.pdf.
[3] “The alarming truth about the number of small businesses in South Africa”, *BusinessTech* (25 July 2018), available at https://businesstech.co.za/news/business/260797/the-alarming-truth-about-the-number-of-small-businesses-in-south-africa/.

WHAT IS GOVERNANCE

King IV™ defines governance as the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes:

- Ethical culture
- Good performance
- Effective control
- Legitimacy.[4]

Governance is a way of supporting ethical and effective leadership. It can be used to create the processes, systems and controls, as well as the appropriate behaviour, to ensure sustainability and long-term continuity in an organisation. In addition, governance will help ensure that decisions are made in the best interests of the organisation, taking into account its stakeholders.

It's perhaps worth noting here that governance is often qualified with the word "corporate". Strictly speaking, this simply means the governance of an incorporated organisation rather than an individual, but "corporate" has also come to be associated with big listed companies, or corporates, in comparison with smaller companies (SMEs), state-owned enterprises or other organisations like non-profits. In order to emphasise that this paper deals with governance as it specifically applies to SMEs, we have omitted the qualifier.

BENEFITS OF GOVERNANCE FOR SMEs

- **Puts the business on the right track for sustainable growth.** Business essentially looks at the balance between risk and reward. This balance is at the heart of business success; considering it formally and within a framework can only aid the business in positioning itself for growth. Governance requires the business to take the long view, and look at its long-term sustainability. This means taking a strategic view even though the primary concern in the early years is simply to keep trading at a profit. All of this is important given that so many SMEs fail within the first two years.

- **Positions the business to gain access to finance and/ or investors down the line.** At a certain point in its growth cycle, every business will need access to new capital. This will be hard to access if the SME cannot demonstrate that it is being properly run; amongst others, this means proper financial records and controls covering a certain period, usually three years. An SME that has been following best governance principles will have this all documented and will thus be in a potentially better position to bid successfully for funding.

- **Positions the business for eventual sale.** In similar vein, a well-governed business is more saleable because it can demonstrate its results convincingly. The sale might be desirable because the SME founder simply wants to cash out at a certain point, but it might also be as part of a merger/ takeover with another company in which the founder will continue to participate. In

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[4] *The King IV Report on Corporate Governance for South Africa 2016*, accessible at http://www.iodsa.co.za/?page=AboutKingIV, p11. Copyright and trademarks are owned by the Institute of Directors South Africa.

either event, a well-run business is a more attractive target for a purchaser and generates a higher valuation for the seller.

- **Promotes better decision-making.** Businesses have to make decisions all the time. A good governance framework (i.e. having a defined strategy, vision and understanding of the core competencies required for success) will help guide the process, particularly in terms of guiding the decision-maker to look at the long as well as the short term implications.

- **Allows for the changing role of the founder.** Start-ups and small businesses are typically reliant on the founder, who fulfils most of the roles. He or she is both managing director and board of directors. But as the business expands, the founder will inevitably have to reduce his or her involvement in day-to-day operations. In other words, he or she will have to rely more on other people. Such a transition is a dangerous time for any business, and the clear delineation of duties and responsibilities implicit in governance will make that transition easier and more successful. Clearly, if there are already policies, procedures, codes of conduct and so on in place, it will be easier for the business to continue being run as the founder would wish.

- **Builds confidence amongst stakeholders.** Even the smallest business has stakeholders: its staff, customers, suppliers and anyone who has lent it money or who is contributing some sweat equity. This group will grow as the business grows, and will ultimately come to include investors, lenders, other members of the value chain, regulatory bodies, the local community and the like. All of them will derive comfort from seeing that the SME has governance frameworks in place and thus is planning to continue trading into the future.

  In essence, then, governance can help an SME build its reputation which in turn can be used as a marketing tool. Take, for example, a Mexican auditor who used his firm stance against engaging with corrupt or unethical clients as a unique selling point in a highly corrupt country. As a result, he was able to establish himself as a highly desirable partner because of his ethical positioning.

- **Better succession planning.** SMEs typically are the product of an individual's vision and drive. As the business grows, it becomes necessary for the founder to consider who would replace him or her in the event of illness, an accident or death. Naturally, this is something that most people simply do not want to think about, but it is a prime cause of business failure—even in the biggest corporates. Governance, with its focus on sustainability and risk management, forces the founder to confront this issue in good time, and thus lay the foundation for long-term sustainability—even if he or she is removed from the picture.

- **Reduced vulnerability to corruption.** The private sector has as much of an obligation as the public sector to stamp out corruption. Adopting a good governance frame of mind from the beginning will help make ethical business practices part of the business's DNA, and reduce the risk of going for short-term gains that put the longer term viability of the business in jeopardy

GOVERNANCE CHALLENGES FACING SMEs

Lack of buy-in or understanding of the benefits of governance and how it is applicable to SMEs.

Entrepreneurs start businesses because they believe in a service or product—that's their main focus. They may not even have much business experience or knowledge. For them, and for SME owners generally, governance can seem like just another compliance burden, a set of boxes to tick. King IV, the latest iteration of South Africa's corporate governance best practice, has introduced a number of innovations to help drive home the message that governance is all about achieving certain (highly desirable) outcomes and boosting bottom-line performance.

To that end, it has reduced its number of principles from 75 to 16, and framed them in terms of ideals to be achieved. Behind each of the 16 principles are a number of recommended practices. The advantage of flexibility is that each SME can take its size and complexity into account when implementing or introducing practices aimed at achieving the desired principal and outcome. This is the concept of proportionality that has been introduced in King IV. In addition, its disclosure regime (that is, how reporting should be done) is now summarised by "apply and explain"—this gives considerable flexibility because it means that the SME can communicate its reasoning, and how the actions it took were aimed at achieving the desired goal. It's no longer possible to treat the recommendations as if simply fulfilling them would magically make the business well-governed.

King IV has a supplement for SMEs, which offers further guidance on how to apply the King Code to smaller businesses.

Proportionality means that an SME can adjust its governance measures to suit where it is in its life cycle. Thus, it can progress from having virtually no formal governance processes during its startup phase to introduce controls and methodologies as the business grows and more employees are hired. Formal governance becomes more important as the business grows, but it is highly desirable to develop good governance habits from the beginning. Implementation of governance practices does not need to be costly. It may be time consuming at first (for example when setting policies and guidelines for the first time), however once the basics are in place and if done properly from the get go, future review, update and implementation becomes easier.

See Benefits of Governance for SMEs section above for a number of benefits applying good governance practices can bring to SMEs

Recommendations for SME:

- Start the process of engagement sooner than later, to fully understand what the introduction of a governance framework can do for the business.
- If you can see the potential benefits of effective leadership then start implementing in the areas where the most benefit will be gained.
- Start setting your governance framework by putting down in writing how you do business and how you would want someone else to conduct business on your behalf i.e. your code of conduct, process follows, policies, strategy, vision and business plans. Start with the basic policies and add as you go along and when you require them.

Limited resources and independence/objectivity

The smaller the business, the fewer resources it has. The principle of proportionality is critical here. In this light, a small start-up in which virtually every job is being done by the founder would have virtually no resources to call on, and no spare cash to fund the services of somebody to provide a non-executive/independently objective view. He or she would have to fulfil the executive and board roles, but a good practice would be to do so by quite consciously adopting the necessary viewpoint for the separate roles. When considering strategy, a different mind-set is required to when one is pondering cash flows or supply chains.

A friend or trusted member of the community can act as a sounding board for the director-type discussions, which would make it easier to don that particular hat, when a full time NED is not possible. This person should have some relevant experience and, in order to preserve independence, should not have a financial interest in the company. It's worth spending some time in finding the right person because this informal "board" can play an important role in the SME's success, and will prepare the business owner to take guidance from a more formal board later.

It would be desirable to put good financial processes in place from the beginning, because financial controls are the bedrock of any successful business.

As the business grows, the need for better governance will grow. It will become less and less feasible for one person to run everything, and as more people become involved, a strong governance framework would need to be in place, always proportional to the scale of the business and its resources.

A specific resource that would be in short supply is the expertise to develop a governance framework. Industry codes are a good place to start and, King IV (including its supplement on SMEs) is a good starting point.

Recommendations to SME:

- Good independent input will challenge your thinking – the secret is to accept it with a positive mindset and see it as constructive not negative.
- The implementation of appropriate governance frameworks will remove stress and will allow the executive to focus on running the business.
- If your business is still too small to afford non-executives or governance services, take a look at your local community and friends to try and identify somebody who would agree to provide the objective input you need to balance your insider's view.
- To develop your first governance framework, download King IV, including the SME Supplement for guidance, and also use any codes published by industry associations in the area in which your business operates. Engage with the IoDSA should you require any training workshops or assistance. The IoDSA offers discounted rates to SMEs..

Succession for founders – who will take over when I leave; Transition from founder/owner to oversight board member/shareholder – letting go of the realms as the business grows; and Raising capital funds

All three of the above challenges have been dealt with under the Benefits section above. Part of implementing governance practices/frameworks includes thinking about succession planning; understanding the different governance roles and having clear roles and responsibilities to ensure separation of duties; putting in place mechanisms to manage reliance on others and overall presenting the organisation as one that is sustainable and investment worthy for a potential investor.

Lack of professional networks

As an SME grows and begins wanting to strengthen its governance capability, one challenge that emerges is a lack of networks to find suitable advisors or non-executive directors. These networks are critical in finding people with the right skills and experience to serve as non-executives.

Recommendations to SME:

- Make the time to network even if the immediate benefits are not apparent, as when the need does arise you will be in a position to move quickly.
- To build your governance understanding and networks with other professionals, look to the IoDSA, your local Chamber of Commerce as well other applicable professional bodies for member benefits
- Engage with the IoDSA to advertise your NED vacancy to its members and Certified Directors. This service is provided by the IoDSA at no charge. In addition, individuals looking for board experience often serve on NPCs and SMEs on a voluntary no-fee basis to gain exposure.

The growing compliance burdens of success

Smaller companies are exempted from many of the formal requirements applicable to larger companies. Coming to grips with these can be challenging, and may even persuade an SME's founder to keep the business below a certain threshold of employees or revenue. This would be a huge pity because making this jump is the only way to grow the business, access large-scale finance and provide more secure employment for staff.

Diversity is one of these challenges confronting an SME as it grows. It needs to be recognised that diversity is actually a source of strength, provided it is properly integrated into the business. The notorious tick-box approach, also known as fronting, can act as a drag on business performance, but the inclusion of people offering genuinely useful new skills and perspective can be extremely valuable. There is research to back this up.[5]

Labour regulations and tax are two others. Smaller businesses are exempted from some labour regulations, and those below a designated revenue also attract less tax.

In addition, there will be a need to implement better HR, labour, payroll and marketing and capabilities, to name just a few. Many institutions exist to help SMEs make this transition, and an SME-specific course at a business school can also pay huge dividends. Most SMEs will find that their accounting service provider is the obvious first port of call for advice as it has both an in-depth understanding of the business and the regulatory environment that affects it.

Recommendations to SME:

- Governance is a journey. If you have spent the time understanding
  - effective leadership,
  - the support frameworks involved,
  - developed a solid network and
  - utilised independent input over time

  then the conversion to or implementation of governance frameworks will be a smooth natural process and they will add value.

[5] For example, Anna Powers, "A study finds that diverse companies produce 19% more revenue", *Forbes* (27 June 2018), available at https://www.forbes.com/sites/annapowers/2018/06/27/a-study-finds-that-diverse-companies-produce-19-more-revenue/#298f5cd8506f.

- Prepare (and budget) for the transition from a more informal to formal business, including corporate structure, tax structure and HR. This may include a greater burden of regulatory compliance.

CONCLUSION

The benefits of governance for SMEs cannot be over-emphasised. Adopting a governance-based approach from the start will not only increase its chances of long-term success, it will also reduce the challenges posed by growth. The principle of proportionality should be carefully applied to ensure that the appropriate level and style of governance is applied in relation to the current stage of the SME's life cycle.

Notes

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