PART 6: SECTOR SUPPLEMENTS
SUPPLEMENT FOR SMALL AND MEDIUM ENTERPRISES

1. SMEs – the macro view and benefits of corporate governance

SMEs are the drivers of inclusive economy and growth as well as societal transformation. According to a 2010 paper on the role of SMEs in job creation in the South African economy, SMEs (defined as businesses employing 1 – 499 people) account for over 76% of the total employment in the economy, and of the net new jobs created between 2004 and 2007, they created 53% of these. The National Development Plan aims that by 2030, 90% of new jobs will be created by the SME sector. However, contrary to global trends where SMEs constitute the largest employer in either developed or developing economies, smaller firms in South Africa are showing stagnation in both turnover and employment growth.

Good corporate governance can unlock opportunities for SMEs in the form of access to finance and markets and developing relationships with customers. Corporate governance furthermore assists with setting up the leadership and other structures as well as the processes and frameworks that position the SME optimally for growth.

2. Scope

For the purposes of this supplement a small or medium enterprise (SME) is defined as a private for-profit company which has a public interest score of at least 350 calculated in terms of regulation 26(2) of the Companies Act, 2008.

3. Terminology

Where King IV refers to ‘organisation’ it should be understood as the company or SME for the purposes of this supplement and ‘governing body’ should be read as board. ‘Members of the governing body’ should be interpreted as directors.

4. Applying the practices in the King IV Code to SMEs

Certain recommended practices in the King IV Code are referenced in this supplement to illustrate how they could be customised to meet the needs and requirements of an SME. It would be inaccurate to conclude that those practices in the King IV Code which are not dealt with specifically in this supplement are not applicable to SMEs.

The essence of King IV as represented by its outcomes and principles applies to SOEs with the necessary adaptation in terminology and are repeated below for ease of referencing.

1 http://www.itweb.co.za/index.php?option=com_content&view=article&id=45967
2 http://smegrowthindex.co.za/
4.1 Proportionality considerations

SMEs include a wide continuum of enterprises that vary largely in size and appreciating this is important when interpreting King IV for application to SMEs.

The principles of the King IV Code apply to all SMEs. Differences in the implementation of corporate governance are accomplished through proportionality – that is, adapting the practices according to where the SME is in its growth cycle and its size, resources and the complexity of strategic objectives and nature of operations. Implementing governance practices is not an end in itself and SMEs should ensure that corporate governance is harnessed for achieving strategic objectives and overall positive outcomes in terms of effects and impacts on the capitals.

The following serves as an illustration of how recommended practices could be scaled in accordance with proportionality considerations:

Where it is recommended in the Code that certain functions should be established – for example risk and opportunity, technology and information, compliance or assurance, a senior employee could be designated responsibility instead of implementing a fully-fledged function. If proportionality considerations warrant it, further scaling could be achieved by allocating part-time responsibility for the function to such an employee. Outsourcing of functions is another alternative and so is sharing functions and resources with affiliated organisations.

A recommendation that a committee of the board be formed could, if justified by proportionality considerations, be replaced by having the board carrying out the functions normally fulfilled by such committee. In the alternative the board could delegate without abdicating accountability to one of its members to investigate, consider and prepare submissions for recommendation and consideration by the full board.

Where the Code recommends that a formal policy be established, it can be accomplished by reducing to writing a few guiding criteria and processes and by continually developing the document as learning evolves. The benefits of being intentional and devoting the necessary thought to putting policies and structures in place should not be underestimated. Doing so clarifies thinking and ensures alignment of understanding amongst all those whom the policy affects.

Applying proportionality in respect of the practices is subject to it giving effect to the principles. Refer to Part 3: Application of King IV practices for more guidance on proportionality.

4.2 Governance and the growth cycle of SMEs

SMEs typically grow from a founding member(s) investing energy, passion and resources over time and sometimes over decades and generations to eventually become a family partnership, consortium or syndicate or even a company that is owned by a number of outside shareholders. The risk is that the governance structures and processes do not evolve and mature as the company does. Corporate governance facilitates stable development.
It is therefore important to ensure that a good governance foundation is established from the beginning so as to ensure it is carried forward and entrenched in the way in which business is conducted. “Governance is thus a long-term commitment that takes time to develop and build momentum and demonstrate clear value. Over time, each year of governance builds upon the last and creates a stronger company”.  

A key consideration in the development of corporate governance in tandem with the growth of the company is the transition of ownership and management. ‘Business growth ultimately requires an evolution from an entrepreneurial to a professionally managed organisation system. A new management culture needs to be introduced. A successful transition should be planned and executed carefully and gradually in four stages: analysis and evaluation of existing business strategy; formalisation of decision-making and information systems of the business; attracting, selection, motivating, training and retaining of key individuals and development of middle management; and constant monitoring of change to insure a smooth transition.”

4.3 Chapter 1: Leadership, ethics and corporate citizenship

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<tr>
<th>OUTCOME: ETHICAL CULTURE</th>
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<tr>
<td>Principle 1.1: The board should set the tone and lead ethically and effectively.</td>
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<td>Principle 1.2: The board should ensure that the company's ethics is managed effectively.</td>
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<td>Principle 1.3: The board should ensure that the company is a responsible corporate citizen.</td>
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The values of accountability, responsibility, fairness and transparency exemplify ethical leadership and should be the cornerstone upon which any enterprise is conducted regardless of size and nature of operations. Principle 1.1 and its practices require the governing body to set the example for ethical and effective leadership by demonstrating ethical characteristics. Thus sound governance and leadership start with a focus by the members of the governing body on their own - individual and collective - character and behaviour.

In addition to setting the example through its own character and behaviour, the board should also ensure that the ethics of the SME is managed effectively in accordance with Principle 1.2.

Due to the critical role that SMEs are fulfilling in the economy and its development they are an integral part of the societal dynamic. SMEs also form part of the supply chain of other companies who should hold their suppliers accountable for responsible corporate citizenship and ethical practices. As such SMEs are corporate citizens and should look at applying the recommended practices pertaining to responsible corporate citizenship in Principle 1.3.

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4.4 Chapter 2: Performance and reporting

**OUTCOME: PERFORMANCE AND VALUE CREATION**

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<thead>
<tr>
<th>Principle 2.1: The board should lead the value creation process by appreciating that strategy, risk and opportunity, performance and sustainable development are inseparable elements.</th>
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<td>Principle 2.2: The board should ensure that reports and other disclosures enable stakeholders to make an informed assessment of the performance of the company and its ability to create value in a sustainable manner.</td>
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Principle 2.1 of the King IV Code deals with strategy, implementation and performance. Objectives, values and vision should inform and be integrated into the business strategies of an SME.\(^5\) Performance should be understood as the creation of not only economic value but as performance within the triple context of the economy, society and the environment within which the SME operates.

The application of the disclosure practices recommended in the King IV Code may vary from SME to SME depending on size, resources and the complexity of strategic objectives and nature of operations and impact of business. Meaningful disclosure is the mechanism by which the board of an SME is held accountable. The practices with regards to disclosure and reports as under Principle 2.2 should be considered by SMEs as a means for meaningful communication and to demonstrate accountability.

Some of the benefits that an SME can derive from reporting include:

- identifying and accessing opportunities and risks (which can serve as early warning systems and provide a competitive edge);
- more informed decision-making both within the business and among the SME’s other stakeholders;
- improved management systems, internal processes and controls;
- improved reputation and thereby ability to attract and retain employees;
- improved transparency; and
- improved performance management, which could improve access to funding as result.

By understanding the connection between sustainability and the business, the SME can measure its business performance, identify areas for improvement and manage change effectively. This will drive performance and innovation within the SME.\(^6\)

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\(^6\) Adapted from [GRI Ready to Report? Introducing sustainability reporting for SMEs booklet](https://www.globalreporting.org/resourcelibrary/Ready-to-Report-SME-booklet-online.pdf), accessible online.
4.5 Chapter 3: Governing structures and delegation

**OUTCOME: ADEQUATE AND EFFECTIVE CONTROL**

| Principle 3.1: The board should serve as the focal point and custodian of corporate governance in the company. |
| Principle 3.2: The board should ensure that in its composition it comprises a balance of the skills, experience, diversity, independence and knowledge needed to discharge its role and responsibilities. |
| Principle 3.3: The board should consider creating additional governing structures to assist with the balancing of power and the effective discharge of responsibilities, but without abdicating accountability. |
| Principle 3.4: The board should ensure that the appointment of, and delegation to, competent executive management contributes to an effective arrangement by which authority and responsibilities are exercised. |
| Principle 3.5: The board should ensure that the performance evaluations of the governing body, its structures, its chair and members, the CEO and the company secretary or corporate governance professional result in continued improved performance and effectiveness. |

**Board as focal point of corporate governance**

Despite the often informal nature of an SME there is a need to put corporate governance on a formal footing and a key element of this is recognition of the board’s overarching leadership and governance role as provided for in Principle 3.1 and its supporting practices.

In an SME a director is often also shareholder and manager. In the interest of role clarity it is recommended that formal processes be put in place to achieve separation when acting in the different capacities as director, manager and shareholder. For example, board meetings should be scheduled separate from management meetings even though the same persons may be involved in both meetings. As the founder’s role changes from shareholder-director-manager to shareholder-director and finally to just shareholder, the degree of involvement and governance structures will also need to change but transition will be easier if role clarity has been accomplished from the start.

Reducing a description of each of these roles to writing will further assist individuals to identify when they should be acting in which capacity especially when specific authorities are exercised. It is recommended that an SME signs a shareholders’ agreement (even if all shareholders are related) and incorporate in this agreement a board charter, a management charter and a delegation of authority.

**Board composition**

Principle 3.2 is applicable to SMEs but the following should specifically be considered.

All directors should as a matter of law exercise independent judgement in the interest of the company. However, having directors who are independent in form in the sense that there is an absence of any interest, position, association or relationship which is likely to affect, or could appear to unduly influence or cause bias may pose a challenge to SMEs due to capacity and resource constraints. Nevertheless input free from perceived and actual bias adds value to board deliberations and serves as an added control. Therefore SMEs should strongly consider...
inviting an experienced and competent person to serve as non-executive and ideally independent director. If this is not possible, such a person may be consulted on an *ad hoc* basis and invited to attend board meetings as and when necessary to obtain objective input until such time as the SME is in a position to appoint a full time independent non-executive director. This initial step should be evolved as the company grows in capacity, resources and consequently impact to include a number of non-executive board members and at least one independent board member who serves as chairman.

Non-executive board members should be formally appointed and fees and obligations agreed upfront. Having a mix of executive and non-executive and one or more independent directors on the board also mitigates the risk that emotive issues drive decision-making, especially in family companies or where the authority of the founding member is entrenched.

Directors of SMEs who are not experienced non-executive directors should undergo corporate governance training so that they are equipped to fulfil their fiduciary duties.

**Appointment procedures**

Many SMEs do not have a separate nominations committee to deal with the selection and nomination of new directors for appointment. It is thus recommended that the board charter sufficiently and clearly outlines the nomination, selection and appointment process, the skills and qualifications required from directors and any other specific criteria that need to be met for directors to be eligible for appointment. Once the SME has grown to the extent that there are a number of non-executive directors serving on the board, a nominations committee should be set up.

Because the roles of director, manager and shareholder are often shared in SMEs, it creates a larger dependency on key individuals. Succession planning for directors and managers should be put in place to ensure that key positions can be filled temporarily on an emergency basis. Succession planning should also provide for a process for permanent succession. This is often a challenge in SMEs and affects business growth and continuity from one generation to the next if not dealt with appropriately.

An effective succession plan cannot be developed overnight but requires deliberate and well thought out processes which are tested and considered over time. “*Criteria should be developed for the successor. The specifications should be clearly communicated to … with a written plan. This plan should describe, inter alia, how the successor will be chosen, what kind of skills and experience will be required, what training and grooming will be necessary and how it should be obtained.*”

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Rotation of directors

In order to ensure that there is a balance of power as envisaged in Principle 3.2, the board needs to ensure that non-executive directors are rotated on a regular basis so as to maintain the independence value that a non-executive provides. For an SME too regular rotation may not be practical or feasible (especially if the SME only has one or two non-executive directors) and thus non-executive directors of SMEs may serve for longer periods than in larger companies. "Finding the tipping point of greatest value-added, or that perfect balance of length of tenure and independence, is pivotal."\(^8\)

Board committees

Principle 3.2 deals with delegation by the board to board committees. Due to capacity and resource constraints, it may not be possible for an SME to have all the board committees as recommended in the Code.\(^9\) With this being the case, the board is responsible to ensure that it addresses those matters which a board committee would have addressed otherwise. If necessary, separate meetings can be set up to ensure sufficient focus on one particular topic or area (such as Audit, Risk, IT, Governance, and Ethics).

Delegation to management

The practices under Principle 3.4 are pertinent to SMEs to achieve role clarity between the board and management.

Performance evaluations

Principle 3.5 and its supporting practices in relation to performance assessments are applicable to SMEs.

4.6 Chapter 4: Governance functional areas

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<tr>
<th>OUTCOME: ADEQUATE AND EFFECTIVE CONTROL</th>
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<tr>
<td>Principle 4.1: The board should govern risk and opportunity in a way that supports the company in defining core purpose and to set and achieve strategic objectives.</td>
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<tr>
<td>Principle 4.2: The board should govern technology and information in a way that supports the company in defining core purpose and to set and achieve strategic objectives.</td>
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<tr>
<td>Principle 4.3: The board should govern compliance with laws and ensure consideration of adherence to non-binding rules, codes and standards.</td>
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<td>Principle 4.4: The board should ensure that the company remunerates fairly, responsibly and transparently so as to promote the creation of value in a sustainable manner.</td>
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<tr>
<td>Principle 4.5: The board should ensure that assurance results in an adequate and effective control environment and integrity of reports for better decision-making.</td>
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\(^8\) See Note 4 above. Page 65.
\(^9\) See section 3.2 of the IoDSA Governance in SMEs Guide for guidance as to when a SME should establish board committees or other formal board structures.
The recommended practices under Principles 4.1 to 4.5 should be applied by SMEs. Where SMEs are not able to implement the recommended structures and functions due to capacity and resource constraints, it is recommended that a shared services model be considered or that practices be applied on proportional basis.

### 4.7 Chapter 5: Stakeholder relationships

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<tr>
<th>OUTCOME: TRUST, GOOD REPUTATION AND LEGITIMACY</th>
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<tr>
<td>Principle 5.1: As part of its decision-making in the best interests of the company, the board should ensure that a stakeholder-inclusive approach is adopted, which takes into account and balances their legitimate and reasonable needs, interests and expectations.</td>
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<tr>
<td>Principle 5.2: The board should ensure that the SME responsibly exercises its rights, obligations, legitimate and reasonable needs, interests and expectations as holder of beneficial interest in the securities of a company.</td>
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Principle 5.1 addresses stakeholder relationships. Due to the often intimate nature of an SME, shareholders may be more involved than is the case with bigger companies. With family businesses shareholders also have personal ties with managers and directors which necessitate communication structures that create a bridge between family and the business matters. It should be considered to establish a forum for shareholders of an SME to raise broad questions. Issues typically addressed in this forum could include: succession planning, growth and return on investment, dividend policy, acquisitions and/or disposals, going public, shareholder sacrifices, management performance etc.\(^{10}\)

Due to the relational proximity of shareholding to the enterprise in an SME, there should be agreement between the company and shareholders on policies for future equity ownership. Such policies should deal, for example, with the transfer, acquisition and disposal of shares in the SME, including the method of valuing shares equitably.\(^{11}\)

The recommended practices under Principle 5.1 should be applied in respect of all stakeholders. Principle 5.2 and its practices are applicable to those SMEs that are investors and funders.

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\(^{10}\) Tony Balshaw, *Thrive! Making Family Business Work*, 2003, p96-97 for more information on the role of the family shareholders' committee.

\(^{11}\) Tony Balshaw, *Thrive! Making Family Business Work*, 2003, p123