Improving the Corporate Value of SMEs in Developing Countries – A Need for Good Corporate Governance

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Abstract
Policymakers now regard SME's rather than the bigger corporations as catalysts for growth. The question then is whether the SME's in Malaysia and other developing countries able to respond to the challenges that are before them.
The aim of this article is to establish that corporate governance should be extended to SMEs as smaller companies also interact with external parties and have business, moral and ethical obligations.
The successful implementation of corporate governance principles enables a corporation to balance the need for managerial risk-taking and entrepreneurial abilities with mechanisms and procedures for monitoring and setting policy so that the actions of management correspond with the interests of shareholders and other interests in the community.
SMEs, many of which are family owned and operated, do form the backbone of Malaysia and other developing countries private sector. The improvement of SME corporate governance is essential to ensuring economic growth and stability as these countries continue to evolve economically and politically.

Introduction
Should corporate governance be also extended to small and medium-sized enterprises (SMEs).
Malaysia and other developing countries have seen a steady growth of SMEs in the last decade. Malaysia's International Trade and Industry Minister, Datuk Seri Rafidah Aziz said SMEs in manufacturing activities have registered a growth rate of 9.2 percent in value-added to RM16.6 billion in 2005.[1] She said output increased to RM82 billion from RM75.2 billion while employment grew to 394,670 from 384,935 in the previous year.[2]

However, Malaysia's SMEs are still fairly underdeveloped and home bound. Also, the SMEs in Malaysia make up 90 per cent of the manufacturing sector but only account for only 10.8 per cent of total manufacturing exports.

After, the East Asian economic and financial crises of 1997/1998, Malaysia introduced a RM7.3 billion economic rescue package and used new strategies towards building sustainable growth. Out of the RM7.3 billion to be spent, the Malaysian governments share amounted to RM1.7 billion, excluding the RM800 million in lost tax revenues which was expected to have resulted from the package. Bank Negara, the central bank, provided RM2 billion in additional funding, of which RM1 billion was to have been channelled to two existing funds, one for SMEs and another for new entrepreneurs and the balance RM1 billion for the special relief guarantee facility for those economically hard-hit by SARS. Other government institutions were to have disbursed an additional RM3.6 billion for targeted priority sectors, of which SMEs received RM1 billion. Thus it can be seen that a substantial amount of the rescue package was used to help-out SMEs. Therefore, SMEs do get hit by financial crises and their performance does effect the economy.

[1] BERNAMA, The Malaysian National News Agency, Kuala Lumpur June 27
[2] Ibid

In a sharp break from the past, policymakers now regard SMEs rather than the bigger corporations as catalysts for growth.[3] The issue then is whether the SMEs in Malaysia and other developing countries are able to respond to the challenges that are ahead of them.

In Malaysia, to raise the competitiveness of the domestic industry, the government has proposed tax cuts on income for SMEs; tax breaks for industrial and agricultural exporters; incentives for machinery and auto components makers and tax exemption on internal charges for professional services within companies.[4]

Further, Datuk Seri Rafidah Aziz said the government is committed to encouraging SMEs to undertake research and development as well as innovation. During the Eighth Malaysia Plan, RM32.5 million had been approved under the commercialisation of research and development fund (CRDF) to facilitate the commercialisation of research and development findings.[5]

However, will this suffice to enhance the growth and well-being of SME's? The aim of this article is to establish that corporate governance should be extended to SME's as smaller companies also interact with external parties and have business, moral and ethical obligations.

1. Corporate Governance

Corporate governance has succeeded in attracting a good deal of public interest in the recent past because of its apparent importance for the economic health of corporations and society in general.

The movement towards greater scrutiny of corporate governance issues has also been developed worldwide. It is widely believed that investors and stakeholders will invest/deal with corporations, which are well managed, best maximise long-term shareholder interests and follow corporate governance best practise. It is important that corporate governance processes are revealed so that investor/stakeholder confidence is enhanced by assurance that appropriate monitoring occurs and procedures are in place.

The development of increased interest in corporate governance reflects higher expectations by the investment community for greater effort by companies to develop their own structures and procedures to ensure appropriate standards of corporate behaviour. The emphasis seems to be on self-regulation rather than legislation. Corporate governance mechanisms have the purpose of monitoring and controlling the management of corporations so as to result in more effective management and to enhance shareholder value. It is said to be a key element in improving economic efficiency and involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

The successful implementation of corporate governance principles enables a corporation to balance the need for managerial risk-taking and entrepreneurial abilities with mechanisms and procedures for monitoring and setting policy so that the actions of management correspond with the interests of shareholders and other interests in the community.

However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomenon.
J. Wolfensohn, the President of the World Bank was quoted as stating that,
"Corporate governance is about promoting corporate fairness, transparency and accountability."[6]

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[3] From The Straits Times, Singapore 29 September 2002 Reinventing Malaysia, Brendan Pereira Malaysia Correspondent
[4] For example in the Malaysian Budget 2002 a tax cut on income of up to RM100 000 was given.
[5] Supra n1
[6] Financial Times, June 21,1999

The Organisation for Economic Co-operation and Development (OECD) defined corporate governance as, *" … the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."*

Others use the expression as if it were synonymous with shareholder democracy. In the mid-nineties Maw et al said,
"Corporate governance is a topic recently conceived, as yet ill defined, and consequently blurred at the edges …. Corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy."

However, it has to be primarily understood that corporate governance is affected by the relationships among participants in the governance system. Shareholders, who may be individuals, family holdings or bloc alliances, can significantly influence corporate behaviour. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from shareholders and management. Creditors play an important role in some governance systems and have the potential to serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance.

2. Importance of Corporate Governance

Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining the objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and the management to pursue objectives that are in the interests of the company and the shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

Corporate governance is only part of the larger economic context in which firms operate, which includes for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long-term success of a company.

The importance of good corporate governance for SMEs are:

a. Good corporate governance ensures transparency, accountability and fairness with respect to shareholders and other stakeholders. It helps build confidence and trust and this allows access to external finance and allows the company to make credible commitments to creditors, employees and others. Here good corporate governance ascertains equitable treatment of all shareholders; establishes clear rights and responsibilities of shareholders, directors and managers; and establishes effective and enforceable accountability standards to help uphold sound management and decision-making processes.
b. Good corporate governance practices will pave the way for possible future growth, diversification or a sale, including the ability to attract equity investors locally and from abroad to free SMEs in developing countries from dependence on high- interest loans. SMEs seeking new funds usually

find themselves obliged to undertake serious corporate governance reforms at high costs and upon the demand of outsiders, often in a time of crises.[7]

c. Good corporate governance also can provide companies with certainty and trust which lead to these companies achieving economies of scale, undertaking risky ventures, engaging in projects with more distant pay-offs and employing innovative work and organisational structures.

d. Of at least equal importance for economic growth is the role of good corporate governance in promoting an efficient channelling of savings to productive investment, especially investment in the fast growing companies that are particularly dependent on external funds.

e. By setting prudent corporate governance rules, procedures and checks and balances to define how the company should be ruled, conflicts, abuses and internal clashes will be reduced, thus favouring the company's growth and profit-making ability.

f. Finally, good corporate governance plays a critical role at every stage of the investment process. In particular:
   - At the very first stage of the investment process, effective property protection and secure methods of ownership registration are basic corporate governance provisions that will influence a company's ability to mobilise equity capital on a large scale;
   - At the second stage, reliable and transparent disclosure is essential if the market is to allocate capital efficiently among alternative uses; and
   - At the third stage, the procedures for corporate decision- making, the distribution of authority among company organs and the design of incentive schemes are examples of governance arrangements that have to be in place for monitoring the use of capital once it is invested in an individual company.

3. Challenges and Issues of Concern

Changes in corporate structures, financial innovation, shift in the corporate asset base and the ongoing process of globalisation all present new changes to achieving and maintaining good corporate governance.
We now need to develop governance tools and incentive structures that are more robust in the face of rapid changes in the growth of SME's.
Several key corporate governance issues are:

a. *There is a need to develop a global consensus on the key prerequisites for a fair presentation of the company in order to limit present inconsistencies and confusion.*
Inconsistencies begin at the most basic level of rules for properly accounting for and disclosing financial transactions. There are discrepancies within as well as between accounting standards. Inconsistencies and controversy also exist at the measurement level of financial disclosure.

b. *There is* a *need for improved governance and regulation of the financial disclosure process*
The required disclosures to the regulatory agencies constitute the backbone of effective capital market regulation. And the standards of financial disclosure, typically issued by an independent body, are the tools used for such a disclosure process. Developments in the 90's have illuminated some areas of weakness in this system. The rules governing financial transactions have in some cases failed to keep up with the complexity of corporate transactions. Concerns have been expressed about both the breadth and timeliness of disclosure.

c. *The integrity and accountability of the Board of Directors*
It is in the interest of the company for the Board of Directors to assume primary responsibility for the management of risk as the company and its investors are the parties that are the most interested in the success and growth of share value. The welfare of the employees of the company and the integrity of their pensions constitute another major responsibility of the Board. One implication of

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[7] Frank Chan, "Corporate governance for the SME" (2003):www.lawlink.co.nz/resources/governance.pdf

this is that companies should do everything possible to ensure the integrity of their management and board.

d. *There is a need for the establishment of external regulatory mechanisms, legal institutions and regulatory bodies.*
Governments should give high priority to the establishment of laws governing the sale of property, the design of contracts, and bankruptcy procedures. Governments should also legislate for good corporate accounting, auditing, and reporting standards. Good corporate governance requires both a flexible market environment and clear and enforceable rules to guide sound business practices. Governments should create public infrastructure necessary to assist in the effective application of corporate and commercial laws, including independent legal systems, prominent, well-resourced regulatory agencies, and professionally trained court officers. The governments in Asia have to address the problems in the area of legal and regulatory frameworks which are demanding immediate attention. Regulatory bodies are being established in the most affected countries to protect shareholder and creditor rights and to promote management accountability. However, the effective operation of regulatory and judicial authorities entrusted with administering and enforcing laws will depend on each authority being properly resourced, employed by high quality staff and operating in a fair and open manner.

e. There is a need for Governments to improve the competitiveness of goods and capital markets.
An open and dynamic private sector is fundamental to the economic stability of developing economies. Competitiveness is a key factor in maintaining the sector's energy and growth. For the best performing companies to attract financing, the overall framework of goods and capital markets must be competitive. An open, transparent and competitive market environment will help ensure that well-managed companies receive funding with lower risk premium than poorly managed and higher risk companies.

4. Why do National and International policymakers need to care about corporate governance for SMEs

There are several good reasons that justify high levels of attention by national and international policy makers:

a. The institution of the limited liability company could not have come about without the explicit backing of public policy and legislative actions. Since the 17th century, governments have had to legislate for limited liability companies. They have had to fence corporate property from the creditors of individual shareholders and vice versa. The effect of this mostly 19th century legislation has been tremendous. Today corporations account for a staggering part of wealth creation in economies.

b. In most countries, the first few decades after the Second World War were characterised by state-led growth. But during the last two decades all of this has radically changed through privatisation. Hence, the role of the private sector corporation as an engine of economic development and job creation has been vested with a new urgency and importance in the last two decades.

c. Privatisation has also been a key factor in the phenomenal growth of equity markets. A growing process of in the financial markets is the shifting of savings from the banking sector to equity (and bond) markets has been the other key factor of market growth.

d. Equity market growth has also been driven by the spectacular growth of financial institutions as equity owners in private corporations.

5. Background to Corporate Governance In Malaysia

In Malaysia, the East Asian economic and financial crisis of 1997/1998 generated a significant amount of analysis and debate, particularly about macro economic issues in the region. In addition it also provoked increased awareness about issues concerning the role and function of regulators and the need for improved disclosure and good corporate governance. While quite a number of public-listed companies adopted relatively high levels of corporate governance, the crisis brought to light instances of corporate abuse and in some cases breakdown in private companies, attributable in part to ineffective corporate governance structures. Some instances of corporate abuse included:

- related party transactions:
- asset shifting:
- transactions involving clear conflict of interest, with no proper disclosure by directors: and
- poor financial management by directors.

Those problems were exacerbated by ineffectual enforcement, difficulties concerning ownership concentration and the limited remedies available to shareholders in Malaysia. In March 1998 the Malaysian Government, in recognition of the importance of enhancing standards of corporate governance, announced the formation of a High Level Finance Committee that would look into establishing a framework for corporate governance and setting best practices for business. While the Committee's focus was on enhancing standards for publicly listed companies, it was hoped that its recommendations for improved corporate responsibility would flow through to all companies, public and private. The Committee made recommendations intended to restore the confidence of investors and overseas markets in the Malaysian capital markets.

It is now recommended that positive steps should be taken for the establishment of a framework for corporate governance and setting best practices for SME's.

5.1 Finance Committee Report on Corporate Governance

In March 1999 the Finance Committee released its Report on Corporate Governance, which contained 70 recommendations pertaining to three broad areas:

- the development of the Malaysian Code on Corporate governance outlining a set of principles and best practice for corporate governance for listed companies
- reform of laws and regulations concerning the duties of directors and officers, improving disclosures, enhancing the rights of shareholders and improving the value of company meetings
- training and education for the corporate sector, particularly in improving the skills and qualifications of directors.

The Finance Committee should now oversee the implementation of these recommendations to enhance corporate governance in SME's.

5.2 The Malaysian Code on Corporate Governance

The role of the Code is to guide boards of listed companies by clarifying their responsibilities and providing prescriptions strengthening the control exercised by boards over their companies. In developing the Code the Finance Committee agreed on the need to adopt international standards of best practice. The Malaysian Code is modelled on the recommendations of the UK Hampel Committee and is premised on a prescriptive approach to corporate governance. The Code outlines a definition of corporate governance and sets out four forms of recommendations and the compliance responsibilities in respect of these recommendations.

The Code should now be introduced to guide boards of SME's by clarifying their responsibilities and providing prescriptions strengthening the control exercised by boards over their companies.

The Finance Committee adopted the following definition for the purpose of the establishment of the Code on Corporate Governance:

> *Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other shareholders.*

Malaysian Finance Committee Report 1999

The Finance Committee's Report is set out in four parts, as follows:
Principles-Part 1 sets out broad principles of good corporate governance for Malaysia. The objective is to allow companies to apply these flexibly and with common sense to the varying circumstances of individual companies.
Best Practices in Corporate Governance-Part 2 sets the best practices for companies. It identifies a set of guidelines or practices intended to assist companies in designing their approach to corporate governance.
Exhortations to other participants-part 3 is not addressed to listed companies but to investors and auditors to enhance their role in corporate governance. They are purely voluntary.
Explanatory notes and "mere best practice"- part 4 provides explanatory notes to the principles and practices set out in parts 1 and 2 and 3. Part 4 also sets out best practices directed at listed companies that do not require companies to explain circumstances justifying departure form best practices-"mere best practices".

The Malaysian Government accepted the recommendations of the Finance Committee. The future challenge is to ensure that these recommendations are also accepted for SMEs by the Malaysian government and other developing countries.

Conclusion
SMEs, many of which are family owned and operated, do form the backbone of Malaysia and other developing countries private sector. The improvement of SME corporate governance is essential to ensuring economic growth and stability as these countries continue to evolve economically and politically. SMEs makeup over 90% of businesses worldwide and account for between 50 and 60 % of employment.[8]

These SMEs tend to employ more labour-intensive production processes. Accordingly, the SMEs contribute significantly to the employment opportunities of the developing countries. It is hoped that SMEs will contribute significantly in halving the poverty levels by 2015.[9]

Further, there is empirical evidence that countries with high number of SMEs have succeeded in making the income distribution more equitable. This ensures long term social stability by reducing income disparities between urban and rural areas.[10]

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[8] Corporate Social Responsibility: Implications for Small and Medium Enterprises in Developing Countries, Report prepared by Peter Raynard and Maya Forstater for UNIDO's small and medium enterprises branch. http://www.unido.org/userfiles/BethkeK/csr.pdf.
[9] Ibid
[10] Ibid

Also SMEs are a key to the transition of agriculture-led to industrial economies as they provide simple opportunities activities which can generate livelihoods.

SMEs are also a seed for entrepreneurship development and provide the foundation for long-term growth dynamics and transition towards larger companies.

Therefore it may be said that for developing countries to eradicate poverty and disparity, it is crucial that there is the development of a vibrant private sector where SMEs play a central part. To ensure that SMEs are vibrant and healthy in developing countries, it is necessary that they practice good corporate governance as smaller companies also interact with external parties and have business, moral and ethical obligations.

Therefore it is recommended that developing countries should introduce codes, rules and/or regulations of corporate governance to enhance the corporate value of SMEs. Further, due to globalisation and other changes these codes, rules and/or regulations should always be evolving to keep abreast with the changes.

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