The Impact of Corporate Governance on Value Creation in Entrepreneurial Firms

Wee Liang Tan & Teck Meng Tan
Singapore Mangement University

Introduction

The compliance with codes of corporate governance has become the norm for listed firms all over the world. In most countries, Entrepreneurial firms do not have to comply with such codes but it has been argued that such codes should also apply to these small medium enterprises (SMEs). Since corporate governance forms the environment for the internal activities of a company and appropriate environmental conditions are crucial for corporate entrepreneurship to flourish in a company, it is apt that these two topics be discussed in relation with each other. Corporate governance mechanisms may dampen value creation in firms if appropriate measures are mandated by the regulators. This paper examines the implications of the extension of corporate governance principles to SMEs and the impact this will have on value creation through corporate entrepreneurship.

Recent Corporate Governance developments in Singapore

The corporate governance movement in Singapore was triggered by the Asian Financial Crisis (1997-1998) in which the Singapore suffered significantly with regards to its previous growth patterns (Mak and Phan, 1999). The cause of the financial crisis is often attributed to poor corporate governance. (Stiglitz, 1998; Harvey and Ropez, 1999); Greenspan, 1999). Following the crisis, several initiatives were undertaken by the Singapore Government to strengthen its financial sector and also to enhance the competitiveness of its economy. In most measures of corporate governance, Singapore's practices exceed its Asian neighbours. However, looking at the FDI confidence index[1], its standards of competitiveness and efficiency are still not on par with world standards of corporate governance. A Corporate Finance Committee, responsible for improving the efficiency of the corporate fund-raising process and corporate disclosure, was formed in December 1997. A steady move from a merit-based regime to a disclosure-based regime is seen following the recommendations of the Corporate Finance Committee. This move also changes the role of regulators and requires fundamental changes to the legal and regulatory framework, accounting and auditing standards, codes of best practices and the role of third-party watch-dogs. (Mak and Chng, 2000).

A review of the corporate regulation and governance was led by the Ministry of Finance, Monetary Authority of Singapore and the Attorney General's Chambers in reply to the changes. Three private sector-led committees were formed in 1999 to execute a review of corporate governance issues in Singapore. They are the Corporate Governance Committee (CGC), Disclosure and Accounting Standards Committee (DASC) and Company Legislation and Regulatory Framework Committee (CLRFC). The CGC is responsible for evaluating international corporate governance best practice standards

[1] The FDI Confidence Index survey tracks the impact of likely political, economic and regulatory changes on the foreign direct investment (FDI) intentions and preferences of the world's largest corporation

against current practices among publicly listed Singapore companies, promote best boardroom practices, and improve director training. CGC submitted.

Shortly after CGC's report of its review and Code of Corporate Governance was submitted, the Code of Corporate Governance based on CGC's recommendations was accepted by the Singapore Government in April 2001. By centering around 4 key areas of board membership, director and executive remuneration, accountability and audit, and communication with shareholders, the Code aims to encourage Singapore-listed companies to improve shareholder value through good corporate governance. It is compulsory for all listed companies to include a complete description of their corporate governance practices with reference to Code provisions in their annual report and to provide adequate explanations when deviations occur.

In March 2002, MAS announced that it is compulsory for banks to rotate their external audit firms every five years. Audit committees comprising of non-executive members of which majority have to be independent was also mandatory for banks. All these changes have to be implemented by 2006. In the August 2002, the Council on Corporate Disclosure and Governance was formed to prescribe financial reporting standards for companies, to strengthen the framework on disclosure practices and reporting standards and also to revise the Code periodically in compliance with international best practices.

Applying Corporate Governance to Entrepreneurial Firms

SME Sector

Companies are considered SMEs if they have at least 30% local equity, fixed productive assets not exceeding $15 million and an employment size that does not exceed 200 workers for non-manufacturing sectors. According to figures released by Singapore Department of Statistics, the total number of SMEs in Singapore is about 105,000.

The importance of SMEs in Singapore cannot be more emphasized. 90% of companies In Singapore are SMEs and they employ more than half of the workforce. However, the SMEs in Singapore only contribute 1/3 of total value added in the economy and this pales in comparison to the SMEs in Hong Kong and Taiwan. It is hence imperative that the capabilities of the SMEs be increased for the future of the Singapore economy. The Singapore Government realizes this and aim to groom SMEs into world class business entities. And to foster growth of a strong SME sector, the government developed initiatives on the organizational, directional and professional level.

The nature of SMEs, family owned and managed, could impede the growth of SMEs. The SMEs tend to retain ownership and management of the business (Tan & Fock, 2001). Professional management practices are also not introduced but this is changing with the presence of government initiatives to introduce new productivity practices.

Corporate Governance and SMEs

There has been a recent growing call for the application of corporate governance to SMEs. The argument is that similar guidelines that apply to listed companies should also be applicable to SMEs. The application of corporate governance to SMEs is on the agenda of a group of experts meeting of the United Nations Commission for Europe to be held in early 2004 (UNECE, 2004).

Corporate governance is largely associated with larger companies and the agency problem. The agency problem comes about when members of an organization have conflicts of interests and within a firm, the separation between ownership and control of firm is often cited. As such at first sight, corporate governance would not apply to SMEs since the agency issues are less likely to exist. Since SMEs only comprises of only the owner who is the sole proprietor and manager, SMEs fall under this category described by Hart (1995). The SMEs are likely to have a few employees who might be the kin of the owner. Since there is no separation between management and owner in SME, some argue there is no need for corporate governance guidelines. Further, SMEs are not accountable to the public since they have not accessed the investing public for funding leading to the questionable applicability of the disclosure and transparency often associated with corporate governance.

Under absence of agency problems, profit maximization, increasing net market value and minimizing costs aims are the common aims of members of an organization. These members disregard outcomes of organization activities and are prepared all these aims. Since these members will be remunerated directly, incentives are not needed to motivate them. The absence of disagreements would also mean the absence of governance structures to resolve them.

Positives of applying corporate governance

On the other hand there are reasons SMEs, especially growing entrepreneurial firms, should adopt corporate governance practices. Growing entrepreneurial firms are defined as firms that have the growth orientation and intention to expand beyond state of survival. Corporate governance has similar benefits to SMEs as to listed forms. As entrepreneurial firms need access to resources for growth, the operations of resource dependence theory also apply to them. Inputs on business operations, good strategy and best practices in industry sectors would be needed. These could be provided for through the presence of external board members which is done same way as in listed firms. In research on listed corporations and corporate governance, it has been found that strategy influences corporate performance (McGahan & Porter, 1997) and that external board members challenge strategies proposed by the management (Pettigrew & McNulty, 1995). Hence if presence of external board members is welcomed, this could culminate to better management decisions. Also, non-executive directors could introduce creativity and innovation into the firm through the opinions and suggestions during decision-making. In a Japan Small Enterprise Agency, SMEs with very high growth rates use non-executive directors more actively than larger firms.

When entrepreneurial firms grow, the need to introduce professional government practices and managers arises. By the introduction of professional managers, the separation between owner and management begins. Despite this development, Agency problems will exist between the non-family professional managers and owners. Incentives must be provided to professional managers in order to gain from their expertise. Next, for best performance from managers, governance of business units must be clear and distinct and accounting controls, internal audits will help to assess the performance of these managers. Despite modifications, agency argument from large firms still applies to SMEs.

Using a stakeholder approach, a firm is not just responsible to its shareholder but also its constituency of stakeholders. These stakeholders include contractual partners, like employees, suppliers; social stakeholders like the members of the community; and the environment. This approach emphasizes long term performance enhancing contributions by stakeholders and also view corporations as socially responsible institutions. Thus, an appraisal of a firm will not only include financial performance but also employment, market share and growth in trading relations with suppliers and purchasers. Since corporate governance can protect the interest of stakeholders, it is suggested it be introduced to SMEs.

Corporate governance allows firms to prepare for their pending initial public offering. The core values of transparency and accountability will be embedded in their corporate culture should corporate governance be applied early. This culture of transparency and accountability would also indicate professional management and good corporate governance is a key foundation for successful and well organized companies.

Introduction of corporate governance will improve SMEs' prospect of obtaining funding from banks, investors and venture capitalists. The presence of proper accounting and bookkeeping practices increase confidence in the firm and makes them less risky to invest or finance. Firms that have information disclosure tend to have healthier growth rates and ratios of ordinary profits to that of capital than firms who do not do so. Firms also will become increasingly committed to business efficiency due to the presence of external supervisory third-parties.

Firms usually will only 3 to 4 years to prepare for their listing on the stock exchange. Currently, firms will only encounter corporate governance during this period and the learning curve is steep. The external absence of board members could mean that they do not gain experience. There firm might be hostile towards external board members as they might regard them as necessary procedures.

Through the presence non-executive directors and effective audit systems, discipline is instilled in the management of SMEs. This is pertinent as the external parties ensure sound management as the management is aware of this external surveillance.

Negatives of corporate governance

The introduction of corporate governance would increase operational costs for SMEs. To fill additional roles in audit, remuneration and nomination committees, new and more directors have to be hired. The more active roles and heavier responsibilities that non executive directors have to undertake would also mean higher remuneration All this would translate to higher start-up costs and deter people from setting up their own businesses and dampen the entrepreneur culture. As many successful businesses worldwide started from small businesses, this outcome could prove undesirable.

This, however, can be resolve by providing appropriate government subsidies. Granted that the government is interested in developing a resilient SME sector, the government would provide the necessary subsidies. Costs will then be reduced and more SMEs would be willing to introduce corporate governance practices. .

Corporate Entrepreneurship

One additional note of considerations necessary to the impact the implementation of corporate governance would have on value creation in entrepreneurial firms. The competitive edge of entrepreneurial lies in the creativity and innovation. It would be disastrous should corporate governance undermine value creation efforts, which in the instance of firms that have gone past the survival and development phases of growth would take the form of corporate entrepreneurship. Thus far our consideration of corporate governance has not considered the impact on internal operations of the entrepeneurial firms. At this juncture, we need to consider the implications of corporate governanceon value creation in these firms

Corporate entrepreneurship refers to the efforts on the part of companies to foster entrepreneurs, innovation and new ventures in the corporate setting. Corporate entrepreneurship is important as a growth strategy and competitive advantage (Pinchot, 1985; Zahra, 1991; Kuratko, 1993; Merrifield, 1993). It also contributes to organization renewal (Guth & Ginsberg, 1990) and profitability (Zahra, 1991). By harnessing innovation and effort of the members of corporation through corporate entrepreneurship, value creation is possible. A conducive environment would allow firms to tap into the innovative talents of their employees and managers. (Hornsby, Kuratko and Zahra, 2002). Thus it is important the organization climate has elements that employees consider conducive. Corporate governance and corporate entrepreneurship are seemingly different topics. Corporate governance, whether broad or wide, focuses on facilitating the profit maximization objective of firms. Profit motive and corporate governance mechanism would contradict efforts to encourage corporate entrepreneurship.

Corporate entrepreneurship can take various forms which Schollhammer (1982) has elucidated.

> *Administrative entrepreneurship.* By engaging in administrative entrepreneurship, the company is taking a step beyond having a traditional R&D department. A philosophy of corporate enthusiasm for supporting researchers exists. This is accompanied by the provision of extensive resources for making new ideas commercial realities.
>
> *Opportunistic entrepreneurship.* The company encourages champions to pursue opportunities for the company, and through external markets.

Acquisitive entrepreneurship. Corporate managers are allowed to seek new opportunities outside the company. This opportunities include mergers, acquisitions, new techonologies and strategic alliances.

Imitative entrepreneurship. Japanese firms epitomize this form of entrepreneurship in their study and reverse engineering of others' products.

Incubative entrepreneurship. Semi-autonomous new venture development units are formed that provide seed capital, access to corporate resources, freedom of independent action and responsibility for implementation from venture concept to commercialization.

How might Corporate Governanceimpact the internal operations of a firm particularly in its value creation activities

To discuss the impact corporate governance has on value creation, close examination on the impact on its internal operations must be carried out. The four main aspects on the internal operations are strategic direction, financial expectations, transparency issues and shareholder activism.

Strategic direction. Strategic direction is what determines the firm's long term direction. Corporate governance requires the selection of presiding board of directors. If the board selection/nomination does not bring in the right thinking individuals then there would be less strategic long term initiatives that might affect the entrepreneurial direction of the firm since this usually implies less funding/attention being paid to innovation and R&D.

Financial Expectations. With corporate governance requiring financial results and in some cases quarterly returns, this might cascade into shortened time horizons for research and development, innovation and other corporate entrepreneurial activities. Hence, if the focus is on the ROI [rate of return on investment] it could be detrimental to the selection, retention and termination of projects, venture teams and employee entrepreneurial initiative. As financial performance parameterized projects, certain worthy projects may be cast aside due to start-up costs. By applying the profit centre concept to units that are undertaking internal corporate ventures, these units may be shut in the short term due to the focus of corporate governance system on the continued profitability. Projects that do not give returns in shorter time frame may be rejected but these projects maybe the ones that generate greater value in the long run. There exists a paradox as these corporate entrepreneurship ventures will eventually generate profit. The performance of managers is linked to projects that choose to undertake and managers would tend to pick projects that have more immediate results. This can prove to dampening on entrepreneurial projects. And if performance criteria are pegged to profit but rewards are not shared with employees, the motivation to initiate corporate entrepreneurship will be absent. This eventuality would result if the focus is on ROI and a shortened period of gestation is permitted to projects. The organizational culture could be affected by what occurs in the board room.

Transparency issues. corporate governancereform has also touched on disclosure and transparency issues. The guidelines issued might require the corporate disclosure of board activities. There is usually a requirement for an audit committee and internal audit. There is also a spate of management frauds which might tempt the regulators or advisory bodies responsible for corporate governance to institute guidelines or to peer into areas where abuse could occur. Unfortunately for value creation activities, the nexus between the activities, their intended results and the actual results might be tenuous or distant, leading any over zealous auditors to rein in value creation activities.

Shareholder activism. One element of corporate governancereform has been to address the concern of one key group of stakeholders – the shareholders. However, shareholders who invest in the firms for the short term are less inclined to consider the longer perspective and there is room for arguing that the balance of the need to know how the corporation is performing and interfering with the firm's activities. Taken to an extreme, shareholders could query the R&D expenditure or firm wide expenses on the development of organizational learning and corporate entrepreneurship.

Designing Governance Systems

A wider definition of corporate governance should be applied here and this wide view of corporate governance, called the stakeholder approach, encompasses the company and all interested parties. The system of governance could thus help or hinder internal corporate ventures. When designing governance systems, it should be kept in mind that instead of just ideal and clear cut systems which often correspond to corporate governance values of accountability, allowances must be made. These allowances include allowing loose groupings of staff across functions, innovation champions. By applying a broad view of corporate governance, corporate governance is not confined to the boardroom and this view allows us to take into considerations that will encourage corporate entrepreneurship.

Conclusion

The importance of corporate governance cannot be more emphasized as it forms the organizational climate for the internal activities of a company. If corporate governance is confined to broad governance, and beyond the board level and one that does not counter-demand innovation, research and development and corporate entrepreneurship strategies, it would have limited operational impact on SMEs. Since corporate governance brings new strategic outlook through external independent directors, it would enhance firm's corporate entrepreneurship and competitiveness which is much desired. It is not a threat to value creation in entrepreneurial firms should the guidelines on corporate governance be applicable.

Note: The authors are grateful to Leong Ying Ying Jeannette for her research assistance and to the SMU Enterprise Development Growth and Expansion program (http://research.smu.edu.sg/faculty/edge.html) for its support.

References

Berle, A. A. & Means. (1932). *The Modern Corporation and Private Property*, NY: Commerce Clearing House.

Bowman, E. H. & Singh, H. (1993). "Corporate restructuring: Reconfiguring the firm," *Strategic Management Journal*, 14: 5-14.

CGC (2001), "Report of the Committee and Code of Corporate Governance," *The Corporate Governance Committee*, March, Singapore from www.sgx.com.sg

Chan, F., 2003. "Corporate governance for the SME." *Lawlink Resource*, Winter, http://www.lawlink.co.nz/resources/governance.pdf;
Financial Review, July 19, 2001

Greenspan, A., (1999). "Lessons from the global crises," *Address to the World Bank Group and International Monetary Fund*, 27 September 1999.

Hart, Oliver (May, 1995). "Corporate Governance: Some Theory and Implications," *TheEconomic Journal*, Volume 105, Issue 430, 678-698

Harvey, C., Roper,A., (1999). "The Asian Bet," *Unpublished working paper*. Duke University.

Hill, C. W. L. & Snell, S. A. (1989). "Effects of Ownership structure and control on Corporate Productivity," *Academy of Management Journal*, 32: 25-46.

Hwang, S.C, K.S. Leong and Y.H. Pang (1998). "How effective are audit committees in

Kosnick, R. D. (1990). "Effects of board demography and directors' incentives on corporate greenmail decisions," *Academy of Management Journal*, 33: 129-150.

Low, Chee Keong (2002). "The Corporate Governance Debate," *Corporate Governance: An Asia Pacific Critique.*

Mak, Y.T. & Chng, C.K. (2000). "Corporate Governance Practices and Disclosures in Singapore: An Update," *Working Paper*, NUS Business School, the National University of Singapore.

Mak, Y.T. & Phan, P.H. (1999). "Corporate Governance in Singapore: current practice and future developments," *Proceedings of Conference on Corporate Governance in Asia: A Comparative Perspective, organized by the OECD and Korea Development Institute*, Seoul, March 3-5th.

Mak, Y.T. (1999). "Corporate Governance in Asia: A Comparative Perspective," *OECD Conference.*

Mallette, P. & Fowler, K. L. (1992). "Effects of board composition and stock ownership on the adoption of 'poison pills'," *Academy of Management Journal*, 35: 1010-1035.

McGahan, A. M. & Porter, M.E. 1997. "How much does industry matter really?" *Strategic Management Journal*, 18 (Summer Special Issue): 15-30.

McNulty, T. & Pettigrew, A. 1999. "Strategists on the Board," *Long RangePlanning*, 20(1), 47-74.

Mitchell A., (2001). "Feeling the chill from Asia's Economic Downturn," *The Australian*

OECD (1999). *OECD Principles of Corporate Governance*, the Organization for Economic Co-operation and Development from http://www.oecd.org//daf/governance/princples.htm

Oswald, S. L., & Jahera, J. S (1991). "The Influence of Ownership on Performance: An Empirical Study," *Strategic Management Journal*, 12: 321-326.

Pang, Y.H and Leong, K.S (2000). Recent Developments in Corporate Governance in Singapore, 25th FAEA Annual Conference, Singapore.

Pettigrew, A. & McNulty, T. 1991. "Power and influence in and around the boardroom," *Human Relations*, 48(8) 845-873.

Robinson, R.B., (1979). "Forecasting and Small Business: A Study of the Strategic Planning Process," *Journal of Small Business Management*, 17 (3), 19-27

Robinson, R.B., (March 1982). "The Importance of Outsiders in Small Firm Strategic Planning," *The Academy of Management Journal*, Volume 25, Issue 1, 80-93. Singapore?" *SES Journal*.

Schollhammer, H. (1982). "Internal Corporate Entrepreneurship" In C. Kent, D. Sexton and K. Vesper (eds.), *Encyclopedia of Entrepreneurship*, Prentice Hall: Englewood Cliffs,NJ.

Stiglitz, J., (1998). "The role of international financial institutions in the current global Economy," *Address to the Chicago Council on Foreign Relations*, 27 February, 1998.

Tan T.M, Pang, Y.H and Leong, K.S (1992). "Are directors' remuneration related to company performance?" *SES Journal.*

Tan, W. L. 1997. "The Impact of Corporate Governance on Corporate Entrepreneurship." In Kao, 1997, *An Entrepreneurial Approach to Corporate Management*, Prentice-Hall: Singapore.

Tan, W. L. and Fock, S. T, "Coping With Growth Transitions: The Case Of Chinese Family Businesses In Singapore", *Family Business Review*, Volume XIV, No. 1 June 2001, p132-140

Thompson, P. & Hung, A. C. (2000), 'Cracking the Singapore Code of Corporate Governance: A Step towards World-class Corporate Governance and Superior Performance?' *Centre for Europe-Asia Business Research*

Trombetta, W.L., (1976)."An Empirical Approach to Marketing Strategy for the Retailer," *Journal of Small Business Management*, 14(4), 55-59.

UNECE, 2004, Information Notice for the Meeting of Experts on Good Governance to be organized by the Coordinating Unit for Operational Activities of the United Nations Economic Commission for Europe (UNECE) on 1-2 April 2004 at the Palais des Nations, Geneva, http://www.unece.org/indust/sme/governance.html

Werksman, 2002. "Corporate Governance." 3:2-3 http://www.werksmans.com/publication/coporate_werks_vol03.pdf.

Williamson, O. (1985). *The Economic Institutions of Capitalism*, New York: Free Press.

Wolfensohn, J.D. (1998). "A Battle for Corporate Honesty," *The World in 1999*, USA, The Economist.