A Study on Corporate Governance and SMEs Financial Performance

Shubha Ramesh
Associate Professor & Head
Dept of Economics
GFGC, Vijayanagar,
Bangalore-5600104

Introduction

Corporate Governance in simple words means the extent to which companies work in an open and honest manner. The Cadbury Committee [UK] in 2002 defined corporate governance as –the system by which companies are directed and controlled. The essence of the corporate world lies in promoting transparency and accountability and in fulfilling the fair expectations of all the stakeholders. Corporate governance thus is one such tool to achieve this goal and to safeguard the interests of various stakeholders. It involves promoting the compliance of relevant laws and demonstrating ethical conduct. The framework of corporate governance encourages efficient use of resources and also requires accountability for the stewardship of those resources. The three key constituents of corporate governance are -Shareholders, Board of Directors and Management. The area of corporate governance has acquired sharp attention in the last decade because of various notable corporate scandals and collapses, such as Enron, WorldCom, Satyam, etc. which involved unethical business practices.

Often, it is held that corporate governance and value creation go hand in hand. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed. Various researches have been conducted to investigate the relationship between corporate governance and financial performance, but the results have been mixed and inconclusive. In this paper, an attempt has been made to examine and analyze the impact of corporate governance on financial performance of Bangalore based select SMEs

Corporate Governance and SMEs
The Micro, Small and Medium enterprises (MSMEs) play a pivotal role in the overall industrial economy of India. MSMEs constitute more than 80% of the total number of industrial enterprises and support industrial development. MSMEs contribute nearly 45% to manufacturing and about 40% to the Indian export sector. Their contribution to the Indian GDP is 8% and the sector has registered growth rate of 10.8%. Indian MSMEs have
moved up from the manufacture of traditional goods including leather, gems and jewelry, agricultural goods to much more value addition in the manufacturing sector to its entry in the value added services as well.

They may look small or inconsequential but are actually the foundation of any economically stable nation. The potential benefits of SMEs to any economy include contribution to the economy in terms of output of goods and services; creation of jobs at relatively low capital cost; provision of a vehicle for reducing income disparities; development of a pool of skilled and semi-skilled workers as a basis for future industrial expansion, among others.

Corporate governance is not a new issue in any economic setting, without excluding Nigeria. Many purposeful organizations give attention for having a corporate governance system with transparent disclosure of information concerning the organization as suggested by various corporate guidelines including agency theory. A given economy is made up of different sub-sectors which however work together for the development of the economy. Such sub-sector ensures to embrace corporate governance before its impact can be felt. SME is one key sub-sector of any economy that deserves corporate governance to be successful

The performance of the SMEs is directly concerned with either good corporate governance or poor corporate governance. This good corporate governance in SMEs has to do with properly managing its assets and liabilities which can dovetail into its success or not hence a systematic risk to the society at large. It is therefore worthy to explore the importance of good corporate governance mechanism in SMEs. Kpelai (2009) asserts that SMEs are the engine room for the growth of any developing economy, because they form the bulk of business activities in developed and developing economies. Corporate governance and SMEs

Traditionally, corporate governance has been associated with larger companies and the existence of the agency problem. Agency problem arises as a result of the relationships between shareholders and managers. It comes about when members of an organization have conflict of interest within the firm. This is mainly due to the separation between ownership and control of the firm. It is alluring to believe that corporate governance would not apply to SMEs since the agency problems are less likely to exist. In many instances, SMEs are made up of only the owner who is the sole proprietor and manager (Hart, 1995). Basically, SMEs tend to have a less pronounced separation of ownership and management than larger firms.

While other side of the argument is that because SMEs have few employees who are mostly known persons to the owner and thus no separation of ownership and control, there is no need for corporate governance in their operations. Also, the question of accountability by SMEs is non-existent since they do not depend on public funds. Especially the sole proprietorship businesses do not necessarily need to comply with any disclosure. Because there is no agency problem, profit maximization, increasing net market value and minimizing cost are the common aims of the members. Members also disregard outcomes of organizational activities that will cause disagreement. They are rewarded directly and as such need no incentives to motivate them. Thus disagreement does not exist and hence no need for corporate governance to resolve them.

In spite of these arguments, there is a global concern for the application of corporate governance to SMEs. It is often argued that similar guidelines that apply to listed companies should also be applicable to SMEs.

Literature Review

A large number of studies have examined the relationship between corporate governance and firm performance. Most of the studies suggested positive correlation. But despite the intuition that good governance leads to good performance by firm, there has been lack of conclusive evidence on this linkage and the results have been mixed

Brown and Caylor (2004) determined that board composition was the most important driving factor among the core factors of Corporate Governance Quotient (CGQ). They also found positive correlation between industry-adjusted CGQ scores and financial performance measures - shareholder returns, profitability, and dividend payouts and yields.

Van de Velde et al. (2005) analyzed the linkage of corporate governance ratings and financial performance, and found positive but not significant relationship between them. This observation is consistent with the findings of Gompers et al. (2003) who further found that firms with stronger governance structure and shareholder rights enjoy higher firm value, profits and sales growth. Governance Metrics International and

Byun (2006) investigated the association between corporate governance ratings and financial performance, and found that companies rated in the top 10% of GMI's global database achieved a higher ROE, ROA and Return on Capital (ROC) than companies in bottom 10%. Selvaggi and

Upton (2008) found that better governed firms yield higher risk-adjusted returns. They strongly emphasized that enhanced corporate governance is the cause of enhanced performance and not vice versa.

Cornett et al. (2009) in their study examined the impact of corporate governance mechanisms on earnings and earnings management in publicly traded bank holding companies in the United States. It has been found that pay-for-performance sensitivity (PPS) and board independence were positively related and the relationship was bidirectional. While both PPS and board independence are associated with higher earnings, their results indicate that more independent boards appear to constrain the earnings management that greater PPS compels. **Al-Abbadi and** Josheva Abor and Charles K.D. Adjasi published a conceptual paper in which they emphasized the extent to which corporate governance framework can be applied to small and medium enterprises. They also discussed the issues further within Ghanaian context.

Indrajeet Dube,(2010) et.al, prepared a report for national foundation for corporate governance, and suggested some corporate governance norms for SMEs and the benefits that they get by implementing them.

Amarjith S.Gill, HarvindS Mand, Neil Mathur (2011) have published an article on "corporate governance and the growth of small business firms in India" in which they examined the relationship between corporate governance and growth of small business service firms in India. They concluded that small business firms should consider changing board size with respect to the firm size.

Enrich Yacuzzi(2011) stated that the key to SME management and strategy is the design of performance management systems, which allow the board of directors, the implementing and monitoring of sound governance systems.

Thomas Clarke, Alice Klettner (2011) conducted a survey of the regulation of corporate governance in SMEs and highlighted a number of policy conclusions like- The need for corporate governance guidelines to include flexibility, particularly for companies early in their lifecycle. He also stated that there is a need to reinforce the robustness of the "if not-why not" approach and educate the market that disclosure, not uniformity,is important.

Shanthy Rachagan, Elsa Satkunasingam, (2012) emphasized addressed an issue saying, it is imperative that the corporate governance practices of SMEs are enhanced by assurance that the appropriate monitoring occurs and procedures are in place.

Parthasarathi Banerjee(2012) said that Small firms have been suffering from poor managerial know-how, poor access to rich factors and poor governance. He argued that small cluster-based exchanges can change this state of affairs. Firms can enhance corporate governance and consequently afford higher resource mobilization with increasing strategic competitiveness if, transactions between cluster firms are encouraged to take place on price and through market clearance.

Almbaideen (2010)in the research paper entitled, "Consequences of financial reporting quality on corporate performance. Evidence at the international level "examined the consequences of Financial Reporting Quality (FRQ) on corporate performance in selected industries. The author used three proxies of FRQ namely earnings quality, conservatism, and accruals quality. The sample size of the study was 1960 international non-financial listed companies from 25 countries for the period 2002-2010. The use of simultaneous equations for the panel data highlighted the positive effect of financial reporting quality (FRQ) on financial performance. This result was robust according to the different measurements of FRQ (earnings quality, accruals quality and accounting conservatism) and for an aggregated measure for the previous three proxies of FRQ. The research showed that this relationship is moderated by the level of corruption perception in the country of origin of the company, the adoption of IFRS, the accounting system used in the country and the influence of the economic cycle.

Azim (2012) used Structural Equation Modeling (SEM) and observed that some governance mechanisms have positive covariance, while some have negative covariance. Thus, he arrived at no consistent and significant relationship between governance mechanisms and financial performance (as proxied by ROE, ROA, Market to Book Value Ratio, Price - Earnings Ratio and Dividend Yield).

Eisenhofer (2010) concluded that, "good corporate governance fosters long-term profitability and it does, in fact, pay." Core et al. (2006) ; and

Statman and Gluskhov (2009) found no significant association between governance and financial performance.

Tyagi (2015) evaluated the impact of corporate governance on the financial performance of Indian IT companies. The sample consists of 20 IT companies listed on NSE Sectoral Index i.e., CNX IT Index. Data was collected from National Stock Exchange (NSE) for the financial year 2012-13 and analyzed with the application of multiple regression. Four corporate governance variables were selected namely: Board Size, Board Independence, CEO Duality, and Audit Committee which were also independent variables in the study. Moreover, the firm's financial performance (ROE) was considered as dependent variable. The findings after regression test revealed that overall corporate governance has a positive impact on the financial performance of selected IT companies in India.

Alhroob & Al-Dalaien (2016) investigated the impact of corporate governance on the financial performance of selected banks in Jordan with the application of multiple regression analysis. The results of regression revealed that there is a significant impact of corporate governance score on the financial performance banks under study.

Thus, it is observed that the past studies suggest positive and significant relationship; while others suggest positive but insignificant relationship; still many others suggest there is no significant association between corporate governance and corporate financial performance. Thus, existing literature provides mixed and inconclusive results. Hence, further empirical examination is required to arrive at conclusive results.

Corporate Governance Component	**Role in Organizations**
Size of the Board Size	Significant role in performance
Independence of Board from Management	A significant role in monitoring and advising the company's management. They safeguard overall organizational and stakeholders interest.
Separation of CEO and Chairman	Conflict of interests can be avoided , if separated
Financial Expertise of Directors	Can take sound financial decisions
Number of Board Meetings	Board should meet sufficient number of times
Role of External Auditors	To detect and report frauds and manipulations in corporate reports
Committees of the Board	Add effectiveness by exercising better control over management decisions
a)Audit committee	Can ensure credibility of corporate reports
b) Remuneration committee	helps decide suitable remuneration package for the top level executives
c) Nomination committee	Evaluates skills, knowledge, expertise and identifies the suitable candidates for the Board Directorship

Statement of the Problem

Corporate governance in the context of the SME sector brings two issues to the fore. Firstly, corporate governance can assist the SME sector by infusing better management practices and offering greater opportunities for growth. Secondly SMEs are constrained by poor financial performance.

Could the adoption of sound corporate governance principles/ practices help the SMEs overcome these problems?

Most of the empirical studies in this area focused their attention on either the impact of corporate governance on SME's physical performance, or the influence of ownership structure on SMEs value . (Claessens, 2002).

The NDA Govt's new economic initiatives such as Ease of Doing Business etc., have contributed significantly to increase in the SMEs overall business transactions. However, the factors such as inadequate supply of finance, high interest rates, prohibitive collateral requirements coupled

with and non-optimal corporate governance practices have limited SMEs financial performance. Hence, the present study would make an attempt to fill this gap.

Objective of the Study
The specific objective of the study is to examine the impact of corporate governance on the financial performance of select SMEs in Bangalore Urban District.

Limitations
The present study is subject to certain limitations.
1. Sample size is small (i.e. 20 companies).
2. Time period of research is 2 years).
3. Market-based measures of financial performance not considered in this study.
4. Study does not consider control variables like age of firm, growth of firm, capital intensity, leverage, risk, R&D intensity, industry type, etc.

Selection of SMEs
The sample comprises of 32 SMEs which were selected on judgmental sampling. They are all located at Peenya Industrial Estate Bangalore. These sample enterprises are drawn from manufacturing, precision tools, ancillary and industrial suppliers segments etc., and are listed in the Directory of Small and Medium Scale industries maintained in the Dept of Industries and Commerce, Govt. of Karnataka.

Sources of data
The financial data was collected from each enterprise. The governance, community, employee and environment ratings data have been obtained from “CSR Hub database”, which adheres to GRI guidelines. CSR Hub rates governance of companies has mainly three indicators, namely, Board, Leadership Ethics and Transparency &Reporting. The study collected secondary and cross-sectional data from the sample SMEs during the two financial year’s viz., 2014-15 and 2015-16.

Data Analysis
Four Accounting-based measures–Returns on Assets (ROA), Return on Equity (ROE), Return on Capital Employed (ROCE) and Profit before Tax (PBT)-have been used as proxies for financial performance. Accounting-based measures of financial performance have been chosen because the audited accounting data tends to provide true and fair view of company and is not influenced by market forces and is considered less deafening in comparison with market based indicators like stock returns, share prices, etc. (Lopez et al., 2007)

The governance ratings of companies have been used as proxy for corporate governance performance. Environment management, community-related and employee-related performance of companies, which are likely to influence the governance of SMEs. The study also assumed control variable ie., size of SMEs (based on investment criteria) using Natural Log of Total Assets.

Hypothesis
(Null Hypothesis) Ho: Corporate governance has no impact on financial performance of Sample SMEs.
(Alternate Hypothesis) Ha: Corporate governance has an impact on financial performance of sample SMEs.
Hypothesis Testing
Various tests like–multiple regression, correlation, t-test and F-test have been performed using SPSS package to investigate the impact of corporate governance on financial performance.

The impact of governance rating of SME (independent variable-GOV) on its financial performance (dependent variable –ROA, ROE, ROCE and PBT); while controlling for size of SME (SIZE) and its performance along employees-related (EMP), community –related (COM) and environmental (ENV) dimensions. The following four equations have been formulated for the analysis:

ROA: $c+b_1+.GOV+b_2EMP+b_3ENV+b_4COM+b_5SIZE$ Eq….1)
ROE: $c+b_1+.GOV+b_2EMP+b_3ENV+b_4COM+b_5SIZE$ Eq…..2)
ROCE: $c+b_1+.GOV+b_2EMP+b_3ENV+b_4COM+b_5SIZE$ Eq….3)
PBT: $c+b_1+.GOV+b_2EMP+b_3ENV+b_4COM+b_5SIZE$ Eq……4)

Descriptive Statistics

Particulars	ROA (%)	ROE (%)	ROCE (%)	PBT (%)	GOV (%)
Mean	16.744	18.280	25.313	8125.604	48.65
Median	13.383	16 .022	15.304	5964.093	40.93
Std.Deviation	12.036	18.377	29.049	8878.038	7. 464
N=32					

Summary of Results

Particulars	R	R^2	Adjusted R^2	F	Significant of F	Beta coefficient for GOV	P Value
ROA	.724	.513	.342	3.281	. 041	1.373	0.21*
ROE	.760	.574	.483	4.012	. 013	1.685	0.29*
ROCE	.878	.591	.411	3.655	.039	3.089	0.16*
PBT	.849	.640	.533	6.098	.017	656.721	0.38*

*Significant at 5% level

Analysis of Results

•The coefficients of determination (R2) values are relatively high (i.e. >.50). Conversely, significance of F values is < .05. Thus, the model fit is good.

• Beta coefficients (b_1) are positive. Thus, Governance rating has positive impact on financial performance of SMEs

•All p-values are less than .05. Thus, Governance rating has significant impact on financial performance of SMEs

•Thus, on the basis of these results, the null hypothesis has been rejected and has accepted the alternate hypothesis

Major Findings

1. Governance rating of each enterprise has a significant positive impact on its financial performance.

2. The positive impact of Governance on financial performance is in conformity with research results of Van de Velde et al. (2005); Cremers and Nair (2005)];Governance Metrics International and Byun (2006); and Eisenhofer (2010). These studies maintain that good governance fosters good financial performance in SME sector.

3. It is found that ratings of company along employees-related and environmental dimensions also significantly influence corporate financial performance.

4. The control variable ie., size of the firm size is also found to have significant impact on corporate financial performance. This result is in line with result of Guindry and Patten (2010)

Limitations

The following are some of the limitations of the study.

1) The sample size is confined to 32 companies units only hence, meaningful generalizations cannot be made.
2) Time period for the study is too short
3) Market-based measures of financial performance have not been considered.
4) The study does not consider control variables like age of the industry, growth, capital intensity, leverage, risk, R&D intensity, industry type, etc.

Suggestions

1.In SME sector corporate governance and financial performance are correlated and governance rating of each company has significant positive impact on its financial performance.

2.This finding may support decision of the company to improve its governance structure and its quality.

3.SMEs should strive hard to improve its performance along with the indicators of good governance – leadership ethics, Board composition & independence, executive compensation, transparency and reporting, stakeholder engagement, and compliance with law in its true sense.

4.SMEs should better understand that improving governance and sustainability performance is as important as improving the financial performance

Conclusion

Thus, corporate governance enables the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. The findings show that there is a significant impact of corporate governance ratings on the financial performance of majority of SMEs. Corporate governance ensures long-term strategic objectives and organizational goals of the respective companies. It is used to describe the way in which companies are directed and controlled. It encompasses issues such as responsibilities of BODs, and the relationships between shareholders, directors and auditors. The essence of corporate governance is about how owners (principals) of firms can ensure that the firm's assets (and the returns generated by those assets) are used efficiently and in their best interests by managers (agents) delegated with powers to operate those assets. In essence, financial performance could be made sustainable provided, there is sound corporate governance in place.

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