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## Corporate governance and business ethics for SMEs in developing countries:

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# **Corporate Governance and Business Ethics for SMEs in Developing Countries: Challenges and Way Forward**

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## **Abstract**

Small and Medium Enterprises (SMEs) are critical for developing countries because of their role in economic growth and poverty reduction. As companies globally face issues relating to transparency, accountability and timely disclosure of material information, the concept of corporate governance and business ethics has gained significant importance. SMEs in developing countries face a number of challenges including access to finance both domestically and internationally, developing international trade linkages. Developing entrepreneurial culture and ethical business environment are also important challenges. The main underlying constraint to their growth is lack of corporate governance structure. There is generally a lack of awareness among these enterprises regarding significance of corporate governance and if there is awareness, there is a general aversion to adopting these practices because of the high cost of implementation. This paper discusses issues facing SMEs in developing countries (particularly in South Asia) and the need for embracing corporate governance and ethical business practices. This paper proposes that an incentive based system for encouraging SMEs to adopt good governance practices is more likely to succeed. It also presents a market based solution through creation of venture services companies for engaging closely with SMEs. SME Chambers can also play a critical in this regard. This paper discusses the framework through a Code for SMEs and suggests mechanism to develop it. Developing and implementing a framework of corporate governance for SMEs needs be a participatory and engaging process. The key components of the Code are also given. Business ethics practices from SME perspective are also discussed. The paper then concludes by giving recommendations to push the agenda forward.

## SECTION 1

### Introduction

Small and medium enterprises (SMEs) are engine of growth in prosperous and growing economy and play an important role in creating economic growth. SMEs contribute to economic development by creating employment for rural and urban population, providing flexibility and innovation through entrepreneurship and increase international trade by diversifying economic activity. Their role in income generation and economic growth for developing countries is critical. In the developed countries SMEs are major contributors to GDP and private sector employment contributing as much as 60% to workforce. In developing countries, they employ more than 70% of labor force. The abundance of labor and the shortages of capital which are characteristics of developing countries are comparable with the SMEs labor intensive character.

In Thailand, SMEs account for more than 90% of the total number of establishments, 65 per cent of employment and 47 per cent of manufacturing value added while in Philippines, SMEs comprise 99 per cent of the total manufacturing establishments and contribute 45 per cent of employment and 18 per cent of value added in the manufacturing sector. Across the South Asia, the contribution of SMEs to the overall economic growth and the GDP is high. It is estimated that SMEs contribute 50% of Bangladesh's industrial GDP and provide employment to 82% of the total industrial sector employment. In Nepal, SMEs constitute more than 98% of all establishments and contribute 63% of the value-added segment. In India, SMEs' contribution to GDP is 30%.

Small and Medium Enterprises constitute a very heavy portion of Pakistan's economy as their contribution in GDP is 30%. According to the Federal Bureau of Statistics (FBS) there are around 3.2 million establishments in Pakistan that fall under the category of SMEs. 90 % of the very small establishments accounts for 80% of all non- agricultural sector employment. All these statistics indicate clearly the crucial role of SMEs in the economic growth of Pakistan and foretell their untapped potential. One of the most interesting indicators is that SMEs contribute significantly to industrial employment which indicates industrialization potential.

A dynamic and vibrant SME sector will provide sustainable growth and generate jobs, reducing poverty levels. SME development is pivotal for pro-poor growth because it makes possible the transition from low to middle- income status. In short they function as catalysts of economic change and in many developed and developing economies have been pioneering new technologies and management methods. Thailand, Turkey, India are just a few of the developing countries that have made swift progress in encouraging and fostering their SME sector.

There are a number of factors responsible for the importance of SMEs in a developing country like Pakistan:

1. They foster an entrepreneurial culture and provide resilience in the economy.
2. They contribute to exports, for example in Pakistan, SMEs dominate the fastest growing export sub-sectors, such as cotton weaving and surgical instruments.
3. They are an important vehicle for poverty reduction through employment generation.
4. Sectors dominated by SMEs facilitate learning geographically and across the sectors. These sectors tend to generate higher levels of competition and mobility, which in turn forces higher levels of learning among firms. This is useful for diversification of the economy.
5. Their efficiency in resource allocation is higher socially in that they provide more employment at lesser capital costs compared to large enterprises. For instance, the Ministry of Labor, Government of Pakistan had estimated that an addition of 16 million persons to the labor force would require an investment of Rs. 5.2 trillion in large scale sector while only Rs. 8 billion in the small/micro scale sector. In the medium scale sector the cost would be Rs. 0.8 trillion.
6. They contribute to reducing inequalities in the economy by distribution of wealth

It is, therefore, imperative for the future economic growth of developing countries to create and promote an environment that nurtures and facilitates the small and medium sector and enables it to realize its true potential. The current situation of SMEs in Pakistan has been researched by various organizations and all reports have documented certain barriers or problems faced by this sector. Traditionally SMEs had been neglected and overlooked by the Government's economic initiatives and policies in favor of larger enterprise. Over the last 7-8 years, the Government of Pakistan has taken numerous pertinent measures to strengthen the SME sector in the country. With the support of various stakeholders, the Government has announced SME Policy (duly enacted as the SME Act in early 2007), which focuses on instituting an enabling business environment, access to finance, human resource development, technological up-gradation, marketing, entrepreneurship development and business development services. The State Bank's Prudential regulations and the setting up of SMEDA are a few examples of this policy shift

## SECTION 2

### Issues Surrounding SMEs

Following are the main issues and challenges facing SMEs

#### 1. Access to finance

Access to equity and finance is a major constraint to SME growth in many developing countries. The existing structure of financial sector only serves large enterprises and commercial banks usually apply conservative policies while lending to SMEs. Majority of the banks consider lending to SMEs an unattractive venture due to a range of factors including information asymmetries and consequently high transaction costs, collateral requirement, financial products not meeting SME sector requirements in medium to long-term.

Credit rationing which is a major constraint to growth is an SME specific constraint that is not binding on large firms. On the supply side, weak creditors' rights because of inefficient legal system and weak governance structures of SMEs lead to information asymmetries resulting in higher transaction costs. The responsibility for the supply side falls on the government and financial institutions. The government through its policies and regulations introduced by the central banks has been encouraging financial institutions to increase their lending to SMEs. Pakistan has a fairly developed financial system spread across the country. There were 6974 branches of commercial banks, in December 2004. Moreover, specialized financial institutions for support of SMEs have also been developed. These include the following: SME Bank, (established 2002), Khushali Bank, (established 2000); The First Micro Finance Bank etc. In addition, all commercial banks have the mandate to provide credit to SMEs and they are in the process of developing their special schemes. The Prudential Regulations of the State Bank have encouraged the banks to give credit to SMEs on the basis of cash flows rather than collateral requirements. Commercial banks have been encouraged to develop specialized SME departments in order to develop financial products according to needs of SMEs. Even with these efforts the government has not been able to significantly increase credit supply by banks and coverage needs to be improved. The State Bank of Pakistan figures show that SME borrowers reached 185,000 in 2007 while total outstanding loans to them were Rs. 410 billion. With over 3.2 million SMEs, this reveals that coverage has been only 6%. This is in the background of high liquidity in the economy and therefore shows significant potential for further enhancing bank financing.

However, it is also important to look at this tendency from the perspective of demand from SMEs for financing. It has been observed that SMEs tend to shy away from formal modes of financing. Similar results have been obtained for SMEs in UK. Italian SMEs using exclusively equity capital are not found to be export-oriented (thus, focused on domestic market); or innovative and usually have a family-based corporate governance

structure. According to SME Pulse<sup>1</sup> which is a survey of more than 600 enterprises in Pakistan, slightly less than half of the firms rely on loans to arrange running finance for their business. About 60% of working capital needs are usually met through personal investment or investment through other family sources while commercial banks contribute only 19% for short-term loans and 16% for long-term investment requirement. This confirms that SMEs do not resort to external financing unless it is absolutely necessary.

External finance cannot be obtained by firms in their start-up phase as their management structures are not transparent and usually have intangible assets. At an early stage an informal kind of financing is usually the main source. This includes owner equity (which then becomes retained earning) or angel financing. Only when the firm is at an expansionary stage of its business cycle that private finance is available through equity and debt as intermediated by venture capitalists and commercial banks. Financing through public offerings of stocks and bonds are not available to these firms until they expand and build their reputation. In majority of the developing countries informal angel capital markets do not exist particularly for SMEs working in innovative sectors or developing innovative ideas. This is because high net worth individuals in these countries either opt for short-term profits or being risk-averse tend to invest in safer sectors e.g. construction and real estate. This implies that SMEs would either need to resort to internal equity mode of funding or formal financing through banks. Nevertheless, the formal financing through banks will come as the firm establishes itself subject to its governance. This will consequently help to graduate the firm to next level i.e. small to medium and medium into large.

In addition to ownership structures, SMEs do not approach formal financing for the following reasons:

- a) High cost of credit
- b) Documentation and procedures required for accessing formal finance are lengthy and cumbersome
- c) Long processing time
- d) Collateral requirements
- e) SMEs can non-registered i.e. working in informal sector and therefore would need to enter into formal economy and consequently face regulations
- f) Disclosure of taxes and burden imposed by inefficient tax authority
- g) Disclosure of information cause the firm to loose confidentiality vis-à-vis its competitors
- h) Perception that banks will start interfering in the internal affairs of the firm
- i) Lack of information regarding benefits of corporate governance for performance of the firm

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<sup>1</sup> Rana, Arif et al. (2003) *The SME Pulse: An Exploratory Study Of The Performance Of SME's In Pakistan And The Characteristics Of Successful Firms*. Lahore University of Management Sciences.

Demand side dynamics are critical because these ultimately link with supply side as well and it again relates to governance of firms through ownership and control structures.

## **2. Family Ownership**

The most important feature of family-owned enterprises is the lack of separation of ownership from control implying that directors and managers cannot be distinguished. This leads to credibility problems as there is no system of checks and balances between shareholders, directors and managers. The duties and responsibilities, and privileges of family members are not clearly defined. Usually in family-owned firms, the family has the requisite voting power to unilaterally dismiss boards or management or to over-rule their decisions. Thus the concept of independent directors does not prevail in these firms. The family usually wants to retain control over the business and see directors with apprehension. The approach of family owners is that they see anything external with threat. It is for this reason that they are not easily convinced to go for external financing.

Other issues for family-owned businesses include:

1. Absence of clear policies and long term planning
2. Lack of outside opinions on strategic direction.
3. Benefits and compensation for family members are not clearly defined
4. Hiring family members who are not qualified or lack the skills and abilities for the organization
5. They usually do not have a succession plan

In South Asia region, family-owned businesses are an important component of the economy. According to SME Pulse, more than 80 percent of the company owners are also the management heads. A high percentage of them (about 98 percent) handle decisions related to all aspects of management and governance in their companies themselves. More than 96 percent of the owners take strategic decisions themselves while 89 percent of the owners take decisions regarding day-to-day affairs, showing a high level of control. Results of the survey show that most of the SMEs are single person ownership firms.

## **3. Internationalization**

A dynamic SME sector is an important complement to a more open economy as experience shows that SMEs contribute significantly to exports. East Asian economies provide models like Japanese through sub-contracting by SMEs with large firms or Taiwanese model through small intermediary agents. SMEs exist in networks of suppliers, buyers and competitors and they are usually dependent on other large firms.

In developing countries, these firms are facing stiff competition from new domestic and international market entrants particularly with the influx of low-cost Chinese products. With higher level of trade deficit in developing countries, role of SMEs in exports will become critical.

SMEs because of their flexible structure are in a better position to forge international linkages. In many countries, SMEs have been able to forge stronger linkages with domestic export-oriented large firms. However, it is now important that SMEs develop linkages with Multinational Corporations (MNCs) perhaps entering through sub-contracting linkages or supply the finished products. Developing countries with cheap labor force can be particularly useful for this partnership. In Pakistan, this kind of international partnership has been witnessed in sports and surgical instruments industry.

These international linkages are important for the following reasons:

- 1) Access to International Markets
- 2) Access to latest technology
- 3) Access to international investors
- 4) Higher exports

Access to international markets will help these SMEs to gain international exposure and realize the importance of innovation. For SMEs in developing countries, access to latest technology is critical. SMEs in Pakistan tend to rely on low and obsolete technology. Moreover, they lack technical skills needed for producing quality products. Developing countries lack high-tech industry and entrepreneurs. This is a major constraint in diversification of the economy as majority of these countries are dependent on traditional exports e.g. agriculture, textile, natural resources etc. It is therefore important to attract international venture capital firms and investors.

International investors are often reluctant to invest in developing countries because their institutions do not provide an adequate level of security for their investment particularly in terms of enforceability of legal rights and governance framework. MNCs and international investors will be willing to forge partnership with SMEs only when their level confidence and trust increases regarding transparency and governance of the local partner. In other words how the firm is being governed is critical to raise investment.

## SECTION 3

### Corporate Governance for SMEs

There is no universally accepted definition of corporate governance. It is basically a set of relationships between a company's board, management, its shareholders and the society within an institutional framework. These relationships evolve into the corporate governance framework, which is “the system by which companies are directed and controlled”. It is essential to recognize that every company operates within a 'unique' jurisdiction of its stakeholders including investors, creditors, employees, managers, and regulators. Good corporate governance seeks to create an institutional framework that encourages all participants to contribute towards better corporate performance aligned with good governance practices. As has been aptly described by Sir Adrian Cadbury in the preface to the World Bank publication 'Corporate Governance: A Framework for Implementation' (September 1999): “Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.”

Good corporate governance leads to development of a framework that provides adequate protection to the interests of stakeholders and reinforces the fiduciary responsibilities of those vested with the authority to act on behalf of the stakeholders. Corporate governance encourages companies and those who own and manage them to achieve their corporate objectives through a more efficient use of resources. Moreover, corporate governance framework should recognize the rights of stakeholders as established by law.

Corporate governance is a significant factor in improving economic efficiency and growth. It has been empirically tested that good governance practices of a company gives a positive signal to investors. With the globalization of markets, international capital flows have become extremely valuable source of external financing. It is essential for companies to observe good corporate governance standards in order to competitively operate in the global capital market and to attract long-term foreign capital. Foreign Direct Investment, which leads to the transfer of technology, is an important factor for economic progress of developing countries. Both the foreign and local investors give importance to good governance practices. In this regard both individual and institutional investors play a role although role of institutional investors is more significant. Therefore good corporate governance is likely to reduce the cost of capital, encourage more stable sources of financing and facilitate the broadening and deepening of local capital markets.

It is critical to consider the effect of economic growth on human welfare. A sluggish economic activity results in poverty and unequal distribution of resources, lack of health and education facilities and unemployment. These issues exist in various under-developed and developing economies.

Good governance is vital for the development of a healthy and competitive corporate sector. As a result a strong corporate sector boosts “sustained” and “shared” economic growth, i.e. growth that can withstand economic shocks and benefit all. It is expected that poverty alleviation and equitable distribution of wealth can be achieved in developing countries by encouraging long-term economic growth through a well-planned and well-implemented approach to corporate governance.

Section 2 has discussed the issues surrounding SMEs which point-out to the need for corporate governance in SMEs. For SMEs, corporate governance is about the respective roles of the shareholders as owners and the managers. It is about establishing rules and procedures to manage and run the enterprise. Corporate Governance is also about setting-up a system of checks and balances to prevent abuses of authority and to ensure the integrity of financial statements. Good governance does not guarantee business success but it is one of the main factors which can help in long-term success. The symptoms of poor governance may not be immediately visible and in the long-run it can cause serious problems.

In case of SMEs, governance frameworks determine the capacity of small firms to raise capital. Financial markets are faced with the problem of information asymmetry i.e. the difficulty of evaluating the quality of the firm’s management framework and protection against moral hazards; hence corporate governance is important. It provides resources to the firms and also helps them to organize these resources. Other key benefits to SMEs include better and stronger system of internal control and accountability, transparency, strategic vision through participation of outside experts on the board, owner to focus more on strategic directions and expansion of business than day to day operations and ability to attract better managers. Corporate governance can therefore be viewed as a mechanism to mobilize and combine resources and competences.

Aawareness regarding significance of corporate governance is increasing in many countries. According to Grant Thompton International Business Owners’ Survey (IBOS) in India of more than 500 mid-sized family-owned businesses, more than 71% have already tightened up internal controls, 25% have appointed non-executive directors and 46 per cent Indian family-owned businesses have formed an audit. This is very promising for Indian economy. However, this is not the case in many developing countries where it is considered that corporate governance is a western concept and that it is applicable only to large companies. SMEs not embracing corporate governance in majority of the developing countries due to the following reasons:

1. There is generally a lack of awareness among SMEs regarding corporate governance and/or its relationships with corporate performance.
2. The costs for implementing corporate governance are too high as compared to its benefits.

Let us examine above-mentioned factors. The lack of awareness among SMEs generally results in increase of financial difficulties, worsening of relationships between SMEs and financial institutions, and decrease public confidence. In developing countries of South

Asia, corporate governance has recently been introduced. For example in Pakistan, the first Code of Corporate Governance for Pakistan was finalized in March 2002 and issued by the Securities and Exchange Commission (SEC). It was subsequently incorporated in the listing regulations of the three stock exchanges (Karachi, Lahore and Islamabad) and is now applicable to all public listed companies (including modarabas and mutual funds). Even, the larger firms have only recently been encouraged to adopt corporate governance. It will take some time before the benefits of adopting it will emerge.

There is a cost associated with implementing corporate governance e.g. appointment of independent directors, developing internal control systems and external audits. There are not enough trained directors available to sit on the Boards and those available are appointed at higher compensation. Similarly it is not easy for SMEs to bear the cost of appointing an auditor. However, these costs are outweighed by the medium to long-term benefits. A potential debtor or investor seeing that the foundations for good governance are already in place during due diligence will have more confidence in investing or giving loan to the enterprise. This will also help in internationalization and diversification in their financing for example through listings in stock market, venture capital or debt market. This will help to develop capital and debt markets in developing countries. In majority of the capital markets in these countries, active trading is done in only a few companies. There have not been many new listings in recent year in stock markets which implies that there is lesser reliance on market for raising capital. Corporate governance will therefore play an important role in developing and deepening financial markets in developing countries. Finally this will help to develop venture capital firms which will promote innovation and technology deepening in the economy.

### **Implementing Corporate Governance for SMEs: Private Venture Services**

The various stakeholders including government, NGOs, international donors agencies have developed programs to build capacity of SMEs in developing countries. However, these are not sustainable solutions. In order to establish corporate governance in SMEs, the model of private venture services is proposed. Under this model, the customized services in complete management and governance of the business would be offered to the SME in return for shares/partnership stake in the business (i.e. profits). These would be offered through venture services companies. Services (non-core business activities) provided would include

- a. Finance and Accounting - Basic Measurements System, Basic Financial Accounting Systems, Basic Financial Analysis, Management Accounting, Financial Analysis for Senior Managers, Assisting in Securing Business Finance and Adoption of International Accounting Standards, Developing Business Plans/Feasibility Report for securing formal credit and preparation of Bankable Proposals;
- b. Sales and Marketing - Marketing Plan Development, Customer & Competition analysis, Strategy Distribution Positioning, Pricing, Packaging, Branding, Media planning, etc. Services shall also focus on identifying and

accessing new markets, linking to export markets, regional trade promotion, international trade fair preparation, etc;

- c. Operational Management – basic productivity tools implementation and quality standards, ISO certification, critical business skill trainings, basic housekeeping and shop-floor management techniques, entrepreneurial skills, implementation of MIS systems, risk management etc.
- d. Governance – introduction and implementation of corporate governance practices and application including identification and education of directors on the way to execute their responsibility, development of internal audit systems and appointment of external auditors.

Under the Venture Services concept, relevant professionals would be available at the partner's premises. The concept is also based on the Islamic mode of financing under Musharaka, which means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture. The idea promotes that while one partner invests in the form of capital in the business, the other partner invests in the form of services. However, unlike Modarabas, profits and losses would be distributed in the proportion mutually agreed in the contract. At the time of entering into the Musharaka agreement, an exit mechanism for the VC provider would be planned. The same would be in a maximum period of 5 years.

The advantage of this approach is that it is market driven and provides a sustainable solution for business development services as well as setting-up good governance practices. Moreover, it also helps to bear the cost of implementing corporate governance with the contribution of a venture services company. This activity can be conducted on the pilot basis which will not only help in awareness raising but also in developing private sector services providers thus providing source of employment and income generation for educated youth. Under this mechanism, an expert organization identifies and builds capacity of venture services companies in those geographic locations where there is heavy concentration of SMEs. These venture services companies will then enter into profit sharing agreement with SMEs for providing above-mentioned services. The venture services companies will also develop capacity of these enterprises and will exit after a maximum period of five years. In this way both venture companies and SMEs increase their profits. This approach will help the sector to graduate to the next level i.e. small into medium and medium into large enterprises. The venture services can be conducted on pilot basis ultimately linked with an SME Chamber.

The strength of SME chamber or their associations in advocacy and their presence varies across the countries. These Chambers exist in countries like Indian and Sri Lanka while in other these chambers do not exist altogether. A large number of sectoral SME associations have been created in Pakistan. Some of these firms are also individual members of Chambers of Commerce and Industries in various cities. Even though these chambers have created SME committees for their advocacy, the fact remains that these chambers look after the interest of large and medium enterprises while not providing due recognition or support to the SMEs, especially the smaller firms. Majority of these chambers are politicized and dominated by established industrialist groups. As a result,

SMEs cannot find a space for themselves to lobby and advocate for their interests and to obtain various services tailored to their needs. Therefore there is a need for an independent SME Chamber to be instituted in developing countries to become the premier advocacy, business support and networking organization. SME Policy 2007 also mentions the need for establishing an SME Promotion Council (including its local chapters) and SME specific Trade Associations for organizing SMEs and providing them with a platform to lobby for organizing SMEs and providing them with a platform to lobby for favourable government policies. Therefore this activity is in line with the government policy but comes from SME ownership which will ensure its sustainability. It is proposed that Chambers of Commerce particularly SME Chambers should take proactive role in not only raising awareness of its members but also assisting them in implementing corporate governance through venture services providers.

## SECTION 4

### Corporate Governance Framework for SMEs

The first step is initiating and generating debate among key stakeholders regarding the need for corporate governance and its implications for SMEs. This will help to increase awareness and at the same time build support for developing a framework. It is important that this mechanism be as participatory as possible.

The next step is the development of Code. This process should be conducted through establishment of a committee consisting of representatives from SME Chamber and Securities Exchange Commission. This draft should then be shared with various stakeholders including Institute of Chartered Accountants, Banking Association and Business Associations. It is important that this process be as inclusive and participatory as possible. Therefore extensive and meaningful consultations should be carried-out with all stakeholders so that ownership of the process is built. For example, in Pakistan, the initiative to develop a framework for good corporate governance in Pakistan was taken by the Institute of Chartered Accountants of Pakistan (ICAP) in December 1998. Later, this initiative was also supported by the SEC and a Committee comprising of representatives from the SEC, ICAP, the three Stock Exchanges in Pakistan and Institute of Cost and Management Accountants of Pakistan (ICMAP) was established. A sub-committee was also formed to undertake the task of formulating recommendations for the first Code of Corporate Governance (“the Code”) for Pakistan. The committee prepared the first draft of the Code in 2000. The draft Code underwent extensive consultation and public debate under the auspices of the SEC. In this regard, a series of seminars were organized in Karachi, Lahore and Islamabad. The draft Code was also circulated by ICAP to various organizations and was placed on the websites of SEC and ICAP to seek comments and suggestions. Various suggestions were received, which were considered and incorporated in finalizing the Code.

After developing a Code for Corporate governance, the next step is to start the process of capacity building of all stakeholders. In this regard, training workshops should be organized for all stakeholders including the owners of SMEs.

Let us discuss various features of this code which would need to be taken account for at the very beginning. The Code would need to be based on the following principles:

- a) Self-regulation i.e. voluntary to adopt rather than enforced
- b) Incorporates the particular needs of SMEs
- c) Flexible so that it can be adapted to the heterogeneous sectors and sizes of SMEs
- d) Not complicated and easy understand for business owners
- e) Should be incentives based such as providing tax rebates.
- f) Other regulations should be amended to make them compatible with the Code in order to avoid regulatory burden and duplication.

An incentive based corporate governance system will also attract informal enterprises i.e. the ones which are not registered. Informal economies are of considerable size in developing countries. It is therefore important to devise a system for formalizing these enterprises. This will ultimately help in documentation of economy consequently expanding tax. Keeping in view the fiscal deficit in these countries, the incentive based corporate governance framework will ultimately have positive impact on macroeconomic indicators.

### **Components of Code of Corporate Governance**

The key elements of a Code usually consist of the following element

- i. Board of Directors
- ii. Corporate Financial Reporting
- iii. Independent External Audit
- iv. Internal Audit

#### **i. Board of Directors**

A Code for large firms emphasizes on independent board. It encourages effective representation of independent non-executive directors, including those representing minority interests as well as institutional equity interest of financial institutions. The directors exercise their powers and carry out their fiduciary duties with a sense of objective judgment and independence in the best interests of the listed company. The Board is also required to establish an audit committee.

The importance of an independent board cannot be ignored even in the context of SMEs. The board provides strategic direction to the firm and help in establishing governance structure. Investors give significant importance to the presence of a board when making investment decisions. In the developing countries, there are not enough trained directors available to sit on the Boards. Moreover, SMEs owners do not want to loose control. Therefore the question arises as to how it would be practically possible for firms to establish a board. It may be more feasible to initiate orientation of SMEs to the concept of board and at the same time establish an Institute of Directors which can be housed at a university or academic institution. This Institute shall at this stage serve to provide capacity building and training to directors. Convincing SMEs of the benefits and importance of Board will be a slow and engaging process.

#### **ii. Corporate Financial Reporting**

The financial statements, prepared by the management of the listed company, present fairly its state of affairs, the result of its operations, cash flows and changes in equity. It ensures that proper books of account of the listed company have been maintained and appropriate accounting policies have been consistently applied in preparation of financial statements and accounting estimates are based on reasonable and prudent judgment. The frequency of these reports is usually quarterly and is an important source of information for investors and banks. For SMEs, the frequency of these reports can be adjusted and

disclosure conditions cannot be stringently applied to them. Nevertheless, systems would need to be developed to prepare financial statements according to accounting standards. This implies requirement of capacity building.

### iii. Independent External Audit

A firm needs to appoint an independent external auditor in order to ensure financial integrity. The role of the auditor is to comment on fairness of financial statements and internal control systems. Investors and creditors analyze the audit report before making their financing decisions. The registered companies are required to submit their annual audited accounts to the regulators. SMEs tend to show aversion external audit due to the following reasons:

1. Cost of an audit is high
2. Apprehension that their financial information would be passed on to tax authorities

As mentioned earlier, it is important that incentives be provided to SMEs for hiring an external audit firm on yearly basis. Moreover, the competition among audit firms has led to decrease in their fee. The audit firms should also be encouraged to develop SME specific audit framework.

### iv Internal Audit

The Code for listed companies requires establishment of an internal audit function. The internal audit reports are provided for the review of external auditors. Establishing internal audit like external audit also bears cost. Therefore, for SMEs, internal audit function should be developed once the firms are in expansionary phase.

It is therefore proposed that the components of the Code be developed after thorough consultations with the stakeholders. Moreover, incentives based corporate governance framework needs to be developed.

## SECTION 5

### Business Ethics

Business ethics is defined as a process for integrating values such as honesty, trust, transparency and fairness into its policies, practices and decision making. Business ethics is therefore inherently linked with corporate governance. The importance of business ethics cannot be denied. The old English proverb “as you sow so shall you reap” is indicative of the significance of business ethics. A firm which applies ethical practices also expects to be dealt ethically. These expectations and consequent adoption of ethical practices create chain effect in terms of promoting ethical practices. While the larger firms have already developed their reputation by adopting these ethics, SMEs around the world are increasingly becoming aware of the importance of good, trusting relationships with customers, employees, suppliers and the community. Moreover, due to their linkages with larger firms through supply chains SMEs are increasingly asked about their social and environmental policies when developing their ventures with large firms.

The advantages of adopting business ethics include:

1. Investors use corporate practices and values as primary considerations in their decision-making;
2. As customers are becoming increasingly aware of their rights, they value ethical practices. Adopting ethics can help to build reputation of businesses;
3. Promoting reputation can help in building customer loyalty and increase in revenue
4. Attracting talented workforce and employees as well as improved performance of existing employees increasing productivity
5. Compliance with regulations e.g. labour laws and environment etc
6. Collaboration with other firms both domestically and internationally

However, SMEs in the developing countries lack awareness and understanding of the importance of business ethics and its advantages. Some of these advantages may not be visible to these SMEs in the short-term e.g. these enterprises would argue that reputation or brand management is not important for them. This is a result of absence of long-term vision and focus on survival in short-term. The reason is obvious: SMEs are more vulnerable to shocks and are focused on surviving in the short-term.

Let us talk about incentives and pressures on SMEs to implement business ethics. In the developing countries where SMEs are suppliers of products for which end user is either the larger firm or individual consumer. When they are linked with larger firms through supply chain, then it is important for SMEs to win their trust. This can be achieved through a combination of delivery of quality product according to the deadline etc. There is a general lack of trust between large firms and smaller ones in that the earlier mentioned do not trust the capability of smaller ones to deliver. This is the main reason where large firms instead of outsourcing some of their functions to SMEs they tend to focus on completing supply chain themselves rather than outsourcing it to SMEs thus

creating economic inefficiencies. Large firms should therefore lead by example by promoting ethical culture. International businesses and multinational corporations should also promote fairness and honesty in business transactions among small firms. This will help to create a culture of trust and fairness. A classical example in this regard is China where trust has been the key factor in growth of SMEs.

The market for SME products to individual consumers is also rapidly increasing e.g. in textile or pharmaceutical sectors. Therefore branding will ultimately become important for them and will gain further importance as these firms graduate into next level. Moreover, with increase in consumers' awareness regarding their rights, there will be increased pressure on businesses including (SMEs) to adopt ethical practices.

Let us consider two important dimensions i.e. relationship with community and with employees.

### **a) Corporate Social Responsibility (CSR)**

CSR implies that businesses need to address the social, economic and environmental impact of their activities. This is also called "triple bottom-line approach". In other words, it is corporate contribution to sustainable development. Recently with worldwide pressure on larger firms, CSR is being integrated into a company's overall business strategies. CSR is linked to sustainable development and is a global issue. Corporate Social Responsibility is achieving commercial success with concern for communities.

CSR has gained worldwide importance. Larger companies allocate a specific percentage of their profits to contribute to social responsibility. There are various forms of this contribution e.g. building schools or hospitals, vocational training, funding NGOs, sponsoring local events, employment to local communities or public service messages on media etc. Most of the research work in literature has also focused on corporate social responsibility among larger firms

Because of their presence in the local communities, SMEs are connected with them strongly. SMEs rely on the prosperity of the local communities in which they operate and vice versa. For example majority of their employees come from the surrounding areas. Similarly communities want SMEs to flourish in order provide job opportunities. As a result of this two-way relationship, SMEs are embedded strongly in their communities. In most small firms, the personal preference of owner influences decision regarding SMEs' external community involvement. With personal interactions, SMEs can build Trust in their communities.

The usual argument given by opponents of CSR by SMEs is that because of their low profitability and lower number of employees, these firms neither have resources nor time to pay attention to CSR. However, SMEs contribute to community through silent CSR because of their relationship with community. Moreover, SMEs which are more concerned about brand development in the long-term, tend to be more conscious about their social responsibility.

Developing standards for CSR, its monitoring and certification is important. However, countries in South see this as a trade and investment protection mechanism by North. There is a danger that CSR standards may undermine SMEs in developing countries. Keeping in view the ground realities in developing countries, it may be un-realistic to force SMEs to comply with formal codes. Lack of access to technology, trainings, environmentally friendly processes and lack of access to international markets are barriers to discharging their social and environmental responsibility.

The most effective mechanism for bringing SMEs into the CSR agenda through the supply chain requirements of large companies, particularly in export sectors. It is therefore the large company which carries forward this agenda through the supply chain. However, it has also come through consumer awareness and consciousness of human rights. In Pakistan, the football industry employed children of school going age. As a result of unwillingness of customers in North to accept child labor and consequently their products, the football industry in Pakistan removed child labor and committed to compliance with international labor standards.

However, when SMEs do not have access to consumers or larger firms in the developed countries, then pressures to adopt CSR are lesser. In those situations, incentives can work effectively. These incentives which focus on productivity of the employees of the firms will ultimately become economically profitable for SMEs.

## **b) Employment Conditions**

For SMEs, issues such as employee motivation and retention are far more important than community responsibility. We argue that as part of business ethics, those issues which are beneficial to SMEs will be immediately attractive to them. SMEs are a major economic force in developing countries upon which a large population in developing countries depends for livelihoods. They are an important source of employment for their communities and in this way contribute to social and economic welfare. It has been observed that SMEs cannot easily find skilled employees when operating in far-flung areas. It is therefore important that they invest in providing vocational/skilled training to employees. However, it may not be feasible keeping in view the costs. The other option is that larger firms take the initiative of initiating vocational training perhaps within a college through public private partnership or government itself takes the initiative. Here SMEs will also be willing to contribute since it will ultimately enhance productivity of its employees thus making them more competitive. In this way both the community and the firm's welfare increases.

The other aspect of business ethics with regards to employees is the working conditions. A small firm is usually dependent on a few employees who perform a large number of key tasks. Therefore it is in the firm's interest to avoid staff thereby creating an incentive for business to adopt good labour practices. Firms with sound business practices and working conditions result in increased productivity of its employees. Because of insufficient resources, SMEs are not able to spend funds on building a formal ethical

culture. However, there are advantages of developing and documenting a formal business ethics policy which will not only create a better of the enterprise but also increase the moral of its employees.

It has been observed that talented and skilled labor force is not willing to work for family-owned businesses. This is because these firms neither pay well nor offer incentives for career growth nor invest in developing their human resources. As a result, these firms do not have good management structures and human capital resulting in lower productivity. The value-added brought by addition of talented human resource is usually missing from SMEs. Managers in these firms (even if they are not family members), usually lack professional training and are unaware of the importance of corporate governance.

On business ethics issues, SMEs need to collaborate with each other and the best mechanism to do this is through their chambers. This will help them to learn about challenges and best practices. We have earlier proposed that SME specific chambers can be useful in carrying forward corporate governance agenda. Working through the venture services will also help in promoting fair business practices. SMEs should also be provided orientation towards developing long-term vision as against short term objectives and how these two are interlinked for business growth as well as benefit of the community.

## SECTION 6

### **Conclusion and Recommendations**

SMEs are critical for developing countries as they facilitate economic activity and provide employment thus contributing to poverty reduction. However, they face challenges related to access to finance, forging international linkages and access to technology. Governance of these enterprises has peculiar characteristics and issues. Corporate governance enhances competitiveness of SMEs by playing an important role in management and mobilization of resources. Corporate governance matters if developing countries are serious about addressing challenges to these enterprises. This paper concludes that incentives based governance framework would need to be developed in order to encourage these enterprises to adopt good governance practices particularly through tax incentives and award of annual trophy. This paper recommends that SME chambers should be strengthened to become advocates for corporate governance and business ethics amongst its members. This paper also recommends that venture services companies for SMEs need to be established and encouraged in order to develop sustainable and market-driven governance solutions as well as creating ethical business culture.

The government should facilitate access to financing and equity markets for firms which implement corporate governance. In order to promote entrepreneurial culture, venture capital firms should also be encouraged through enabling regulatory environment. The developing countries need to reform judicial and legal system in order to ensure investor protection

The Code should be developed with the consultation and ownership of SMEs and it should be flexible to incorporate different features of corporate governance for firms at different stages in the business cycle, according to the capabilities of the company and the needs of investors. In other words, the Code of Corporate Governance should be a living document. It should be dynamic and flexible.

Ideally, first draft of the Code should be widely circulated among the corporate entities, chambers and associations, professional bodies, academia, industrial unions and public in general. This advocacy and awareness raising will encourage private sector to comply with the Code. This will also help to develop long-term public-private relationship.

Monitoring and compliance of good governance practices shall remain a key challenge for all the developing countries. It is therefore, imperative to strengthen the capacity of the regulator in understanding the needs of SMEs. Corporate Governance Unit within the regulator should be strengthened so that it can provide guidance to SMEs on issues related to corporate governance. It should also forge linkages with academia and industry to develop and disseminate policy-oriented research since there is more research work needed on corporate governance for SMEs from the perspective of developing countries. The capacity of the regulator should be strengthened in collecting and analyzing data and

statistics regarding these enterprises. Civil society role in monitoring compliance also needs to be enhanced.

SMEs with their presence in local communities contribute to its prosperity particularly by providing employment. The paper suggests that these firms should focus more on hiring and retaining skilled labor force and in this way contribute to creating ethical working environment.

Finally, it is recommended that information sessions should be conducted with banks, investors, stock markets and other financial institutions. This will help to sensitize them about specific requirements of SMEs. Audit firms should also be encouraged to develop SME specific costs.

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