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Harnessing the benefits of Corporate Governance and Internal Audit: Advice to SME

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Abstract

Small Medium Enterprises (SME) are vital to economic growth in Malaysia and many emerging economies as they are major contributors to the gross domestic product. It is therefore imperative for SME to strengthen its governance, risk and control (GRC) system that is recommended by Corporate Governance (CG) code to support strong business performance. Internal auditor is the right party to provide assurance and consultancy on GRC for a firm to stay competitive. There is generally a lack of awareness among these enterprises regarding significance of internal audit and if there is awareness, there is a general aversion to adopting these practices because of the cost of implementation. This paper was carried out solely through analysis of extant literatures. We identified from reports and previous studies that SME failures are contributed by several factors including low productivity, lack of financing as well as inadequate skills and capabilities. The corporate governance literature posits that companies may achieve strategic, tactical and operational efficiency by embracing good CG principles which include risk management and controls mechanism. Further, internal audit enhance CG through assurance and consultancy work on GRC. Based on the findings from the review of extant literatures, it was found that current status of CG in SMEs are not impressive at all, mainly because of lack of awareness as well as high cost of implementation involved. However, good governance is still deemed important; hence we may argue that a separate set of corporate governance framework may work better for SMEs, similar to the adoption of a separate set of IFRS for SMEs.

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1. Introduction

Small medium enterprises (SMEs) form the backbone of the economy of many developed countries. In Malaysia, SMEs recorded a total of 645,136 companies operating their businesses in Malaysia, representing 97.3% of total business establishments. (Malaysian Department of statistics, 2011). Going forward, Malaysia's new growth model would require a strong drive from SMEs to drive the economy. The SME Corporation of Malaysia has unveiled its masterplan to boost SME contribution and performance by the year 2020 (SME Corp, 2012) The initiatives to develop and enhance SME is a global phenomenon where Malaysia is not spared in the global trajectory. Numerous studies have been conducted and reports published by various parties such as European Commission (EC) Observatory Survey on SME published in 2002, 2003 and 2007. The Organization for Economic Co-operation and Development (OECD) also publish several reports including the recent publication on Financing SMEs and Entrepreneurs 2012: An OECD Scoreboard. In Malaysia, SME Corporation of Malaysia which is an agency established by the government to champion growth of SME has released its 2012-2020 Masterplan last year. This agency which was established way back in 1996 has implemented various programme to help build sustainable and resilient Malaysian SME's yet more need to be done in order to bring local SME's to be at par with their global counterparts. The Masterplan (2012) explained that one of the major characteristics of SME's in Malaysia is low productivity as compared to its capacity. In addition, there are also problems in relation to the entrepreneurs' attitude such as lack of skills and confidence. Such characteristics if not properly handled may contribute to business failures that can be detrimental to the SME community. Given that SMEs are vital to economic growth in Malaysia and the government is seriously driving the force to transform, it is therefore imperative that researchers should take the initiative to explore how the enhancement of CG in SME through internal audit assurance and consulting may be harnessed to assist SME achieve its goals. When there is effective CG, companies will ultimately achieve effective GRC implementation and monitoring (Drew, Kelly and Kendrick, 2005). This paper seeks to find out what is the current status of corporate governance of SMEs in Malaysia and the challenges that SMEs face in adopting good corporate governance (CG). In addition, this paper also seeks to find out if a different set of Corporate Governance framework should be developed specifically for SMEs. This paper was carried out solely through analysis of extant literatures. The discussion is organized as follows: it will start with some background and definition of SMEs followed by explanation on CG, risk, controls and internal audit. Section three will highlight benefits of adopting good governance as well as current status of CG and SME. Thereafter, we will discuss the challenges that SME may face in adopting internal audit and CG. The paper will then highlight some recommendations for way forward. Lastly, the paper ends with conclusion and limitation of the study.

2. Literature Review

2.1. Definition of SMEs

According to the SME Master plan (2012), Malaysian SMEs can be grouped into three categories: Micro, Small or Medium. These groupings are decided based on either:

- The number of people a business employs OR
- On the total sales or revenue generated by a business in a year.

Number of full time employees

	Micro- enterprise	Small enterprise	Medium enterprise
Manufacturing, Manufacturing-Related Services and Agro-based industries	Less than 5 employees	Between 5 and 50 employees	Between 51 and 150 employees
Services, Primary Agriculture and Information & Communication Technology (ICT)	Less than 5 employees	Between 5 and 19 employees	Between 20 and 50 employees

Annual Sales Turnover

	Micro- enterprise	Small enterprise	Medium enterprise
Manufacturing, Manufacturing-Related Services and Agro-based industries	Less than RM250,000	Between RM250,000 and less than RM10 million	Between RM10 million and RM million
Services, Primary Agriculture and Information & Communication Technology (ICT)	Less than RM200,000	Between RM200,000 and less than RM1 million	Between RM1 million and RM million

Fig. 1. Micro, Small, and Medium Enterprises

This is a common definition adopted by Malaysia to facilitate identification of SMEs in the various sectors and sub sectors which hope to facilitate the Government in formulating effective development policies, support programs as well as provision of technical and financial assistance.

2.2. Challenges faced by SMEs

A number of studies have been performed on challenges faced by SMEs in developing countries as well as Malaysia. Some of them worth mentioning in Malaysia are as follows:

Asia Pacific Economic Corporation (APEC) in its survey (1994), highlighted key challenges relating to obtaining loans, a lack of proper coordination amongst the country's SME development agencies, an inability of SMEs to participate in the mainstream of industrial development, underutilization of available technical assistance and other incentives and a lack of skilled and talented workers.

Small and Medium Industries Development Plan (SMIDP) in its 2001-2005 report (SMIDEC, 2002) and SME Masterplan (2012) identified many challenges faced both at the domestic and international levels. These challenges can be summarized as follows:

- Innovation and technology adoption (low commercialisation , poor technology uptake)
- Human capital development (lack of job readiness of employees and effectiveness of training)
- Access to financing (limited non-banking avenues, poor credit worthiness and lack of know how /resources);
- Market access(information barriers for exports, low marketing and branding);
- Legal and regulatory environment (Licensing and permits issues, compliance to regulations); and
- Infrastructure (trade clearance and facilitation system and low/infrequent trade volumes).

The above findings are consistent with findings from extant research such as Ting (2004) , UPS (2005). Saleh and Ndubisi (2006) which found challenges facing Malaysian SMEs including human resource constraints; lack of access to finance; inability to adopt technology; and lack of information on potential markets as well as identified a number of key challenges facing Malaysian SMEs.

These past studies above have summarised a broad understanding of the challenges faced by SMEs in Malaysia and East Asia. However, there has been very limited empirical evidence. Study by Saleh et al (2008) fills this gap by conducting a robust empirical analysis of the major challenges affecting SMEs and their business performance in Malaysia. Saleh et al found that perceptions of government policies and availability of infrastructure are perceived as the major challenges faced by Malaysian SMEs. The third and fourth challenges were perceptions of business competition and availability of infrastructure. Interestingly, on the other hand, financial issues were not seen as an important challenge faced by SMEs.

2.3. *Corporate Governance, Risks and Controls (GRC)*

According to a quote from the Cadbury Report, Corporate Governance is ‘the system by which companies are directed and controlled’. In Malaysia, the Malaysia Code of Corporate Governance (MCCG) which was initially issued in 2000 and revised several times in 2007 and latest revision in 2012, sets out the principles and best practices on structures and processes for public limited companies to achieve good governance. However, it does not limit other types of companies to adopt the code. As defined by the MCCG, Corporate Governance is ‘the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of stakeholders’.

It is essential that the board understands the importance of corporate governance. The quality of corporate governance will have a profound impact on the:

- efficiency of assets use
- ability to attract low-cost capital
- ability to meet societal expectations
- overall performance

MCCG generally identified four important pillars of corporate governance which are the Board of Directors (BOD), Senior Management, Internal Auditors and External Auditors. In addition the revised MCCG (2012) sets out 8 principles of good corporate governance as follows:

1. Establishing clear roles and responsibilities of the BOD
2. Strengthening the composition of the BOD
3. Reinforcing independence
4. Foster commitment
5. Uphold integrity in financial reporting
6. Recognise and manage risk
7. Ensure timely and high quality disclosure
8. Strengthen relationship between company and shareholders

As we may note, principle number six of MCCG (2012) advocate proper risk management and internal control system to be implemented by BOD to ensure the companies objectives can be achieved. Further, MCCG (2012) recommends the following:

“The board should determine the company’s level of risk tolerance and actively identify, assess and monitor key business risks to safeguard shareholders’ investments and the company’s assets. Internal controls are important for risk management and the board should be committed to articulating, implementing and reviewing the company’s internal controls system. Periodic testing of the effectiveness and efficiency of the internal controls procedures and processes must be conducted to ensure that the system is viable and robust. The board should disclose in the annual report the main features of the company’s risk management framework and internal controls system”. In addition,

MCCG recommends that companies to establish internal audit function that reports directly to Board Audit Committee.

2.4. Internal Audit and its relationship with GRC

Having an internal audit function in the firm is one of the key elements of a good CG practice.

This section now looks at what roles the internal audit play in CG and what are the challenges faced by SMEs in relation to Internal Audit.

As defined by the Institute of Internal Auditors (IIA), ‘Internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.’

The mere definition of internal auditing and the standards drawn up and implemented by the IIA give the internal auditor the obligation to contribute in any way possible (consulting or assurance) to the evaluation of the GRC. In addition, the audit committee (BOD) and the management relies ‘heavily’ on the internal auditor for its review of the system of internal control as prescribed by corporate governance codes and recommendations.

Therefore, it is not surprising that the IIA puts a lot of effort in guiding its members to become GRC specialists, capable to assist both management and the board. The IIA does so by continuously discussing, commenting, recommending and training on different aspects of corporate governance in general and on audit aspects in particular.

The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- promoting appropriate ethics and values within the organization
- ensuring effective organizational performance management and accountability
- effectively communicating risk and control information to appropriate areas of the organization
- effectively coordinating the activities of and communicating information among the board, external and internal auditors, and management.

One may argue that internal audit can help with the implementation of good governance. However, there are many challenges faced by SMEs in relation to implementation of an internal audit function in their enterprises.

3. Benefits of adopting GRC in SME

According to Hart (1995), most SMEs are only made up of the owner who is also the proprietor and manager. In other words, SMEs do not have much pronounced separation of ownership and management as compared to larger firms. In addition, SMEs do not have public accountability unless they are listed.

Despite of all this arguments, SMEs should be able to benefit from applying corporate governance similar to benefits reaped by listed companies. Currently, there are little empirical investigations on how adoption of corporate governance benefits SMEs in Malaysia. There is a study performed on Ghanaian SMEs by Abor and Adjasi (2007) and findings showed that there are indeed benefits of applying corporate governance in SMEs. Summary of findings by Abor and Adjasi (2007) on the benefits of corporate governance to SMEs are as follows:

The existence of external board members who are independent non-executive (for example audit committee members) could lead to better management decisions and help SMEs to obtain more resources. This is especially so for growing entrepreneurial firms. Not much empirical research has been done on benefits of CG on SMEs as compared to researches on benefits of SMEs on listed companies. As advocated by Pettigrew and McNulty (1995), external board members will challenge strategies made by management of listed firms. By including external board members, this is claimed to be able to help more independent practices in running the business and attaining profits. This will help improve internal control systems which will result in more accountability and higher profitability through better risk management.

In addition, applying GRC, firms will be able to help free up owner operator from operational duties as well as prevent disputes (Abor and Adjasi, 2007). SMEs with good GRC will be able to attract additional funding from investors as well as pave the way for their initial public offerings.

Furthermore, findings by Rachagan and Satkunasingam (2009) showed that most SMEs in Malaysia are with concentrated ownership/shareholding, in order to protect the minority shareholders, good GRC is essential in SMEs, even though some may argue that agency problem arising from conflict between owners and managers may not exist in such SMEs.

After review of the literature on benefits that good governance bring to SMEs, we should now look at whether the framework adopted should be that similar of the listed companies’.

3.1 Governance and Performance at SMEs

Generally, SMEs should have simpler governance structures compared to larger firms. They do not have complex systems, mostly are family controlled but may still be able to have good governance. Several studies have shown that SMEs do not necessarily need to have the same corporate governance framework as the one adopted by public listed companies.

Yacuzzi (2005) noted the following findings:

- Founders of SME have positive effects on productivity of the firms.
- Transferring ownership and control away from the founders of the SME will reduce productivity, holding all else constant.
- Closely held ownership is not a barrier to productivity.
- Non-executive directors on the board help increase productivity.
- Human capital also helps in productivity in small firms, especially relationships between board of directors, management and workers. This is further supported by findings by Cowling (2003) which found that there is a positive and significant effect from the founders, the board and the management.

Study by Liang and Li (1999) on small private firms in China found that presence of outside directors does contribute to higher return on investment. However, this study also found that the firms were still mainly dominated by people internal to the firms and that duality of titles does not affect firm performance.

Chhaochharia et al. (2004) reported that costs of implementing governance rules by small firms might be larger than their benefits which supported the findings of the study that small firm that make large governance changes showed lower returns.

From the review of the extant literatures above, it can be argued that SMEs do not necessarily benefit from applying the same CG framework as that of the listed companies. In the next section, current status of GG and SMEs in Malaysia, in particular will be discussed.

4. Current status of CG and SMEs

According to study by Mahmood (2008), SMEs in developing countries fail to adopt CG mainly due to two reasons. First of all, there is lack of awareness regarding CG and its benefits to corporate performance. Even listed companies are only encouraged to adopt best practices of CG and only recently in some developing countries that listed companies need to adopt Corporate Governance. It will therefore need some time before companies, especially SMEs to be appreciative of the benefits of CG. The lack of awareness among SMEs is therefore not surprising. Many SMEs do not see the direct benefits of adopting CG.

Secondly, the cost of implementing CG is too high for SMEs compared to its benefits. Cost needs to be incurred for appointment of independent directors, for setting up of internal audit function and developing of internal control system. However, the medium to long term benefits of adopting CG in SMEs may still outweigh these costs.

From the literature findings by Mahmood (2008), the current status of CG of SMEs is not impressive at all. The following challenges discussed in the next section faced by SMEs has somewhat cause the current unimpressive status of adoption of CG among SMEs.

4.1. Challenges in relation to adoption of CG framework

As mentioned in Section 4.1 above, there are in general many challenges faced by SMEs in Malaysia. This section now discusses the challenges that relates to the adoption of CG among SMEs.

A study by Mahmood (2008) highlighted some important findings on challenges faced by SMEs in adopting a good CG. The study found that most SMEs in Pakistan faced barriers in adopting a CG with the good key elements as follows:

- **Board of Directors**
The study found that main issues faced by SMEs when adopting CG was there was insufficient trained directors that could be appointed on the board. On top of this issue, many owners of SMEs were also not willing to lose control. Hence, they are unwilling to appoint external board having this concern in mind (Moodie, 2006). It will be a slow and engaging process in convincing SMEs of the importance and benefits of a Board.
- **Corporate Financial Reporting**
Currently most reporting systems of SMEs are much simpler than that of listed companies. In order to adopt good CG, systems need to be developed to prepare statements according to standards which require incurrence of additional resources.
- **Independent External Audit**
Appointment of independent external auditor is one of the key elements of a good code. SMEs tend to show aversion to the appointment as there will be high cost involved and there is also apprehension that the financial information will thus need to be provided to the tax authorities.
- **Internal Audit**
SMEs find it too costly to appoint internal auditors. However, if SMEs were to adopt the code of CG, appointment of internal auditor may also be mandatory. SME's may also choose to appoint outsource internal auditors provided by public accounting firms including Big 4. Some SME choose outsourcing due to quality factor (Van Peurseem and Jiang, 2008).

4.2. Challenges faced by SMEs in relation to Internal Audit

The importance of role of internal audit in the implementation of good governance is no longer a surprise. However, this may hold true only in bigger or listed firms which can afford the time and cost to have an internal audit function in its organisation. As for SMEs, cost of setting up an internal audit department may far outweigh the benefits of having one. High cost of setting up internal audit function may be too much to bear for SMEs.

In addition, the ownership concentration (Rachagan and Satkunasingam, 2009) in most SMEs prevents the owners/CEOs of SMEs to relinquish a lot of roles. This will deter the effective functioning of a good internal audit function. One other challenge faced by companies is to ensure good quality internal auditor. It is no longer easy to find the head of internal auditors with good qualification. This is already a problem in current listed companies, good internal auditor is hard to come by and this problem will be more prevalent in SMEs since SMEs usually will not be willing to pay too much to hire a highly qualified internal auditor (NST, 2012, 24 Oct).

Another main challenge faced is obviously the lack of governance in Malaysia in regards to the mandating of internal audit function. It was only until beginning of this year that public listed companies are mandated to have an internal audit function in the company. This is only mandatory for listed companies not SMEs (MCCG, 2007).

5. Way Forward - Development of good GRC framework for SMEs

Based on the review of the available literatures on GC and SMEs, brief conclusion can be made on the many challenges faced by SMEs in Malaysia in adopting a good GC framework. A lot of times, SMEs faced issues of not having enough support as well as not having enough resources. Studies by Mahmood (2008) and Clarke (2006) have discussed about the need to develop a GRC framework for SMEs.

Clarke (2006) argued that, "SMEs are forgotten stakeholders in the fair and efficient management of Australian corporate governance. This is principally because the 'corporate governance market' is essentially aimed at listed and other public companies. It is assumed that rules, norms and best practice will somehow magically trickle down

to SMEs, but neither resources or practical guidance are offered for multi-tasking managers of SMEs. It is only by default that the system of corporate governance takes into account the interests of SMEs. The current approach is both politically unfair and economically inefficient. Legislators need to re-imagine the contemporary nature and architecture of SMEs; in this way, corporate governance can be refigured so as to better reflect the particularities of, and challenges faced by, Australia's huge array of SMEs".

According to Clarke (2006), corporate governance regimes are normally drafted for larger listed companies and do not meet the needs of SMEs. The cost of compliance with such regimes will far exceed the benefit. A separate code for SMEs needs to be developed to help SMEs achieve good governance. This is similar in Malaysia as well, the MCCG are best practices meant for listed companies and it will be a burden if SMEs are required to adopt these codes as well.

The problem with agency theory and, indeed, with other corporate governance modelling devices such as moral hazard theory and remuneration policy which seeks to better align the two disparate groups, is that they hold very little traction for SMEs. Nevertheless, these theories have, and continue to form, the bedrock thinking of legislators and regulators (Clarke, 2006).

Clarke (2006) suggested the following approaches to avoid the continued over-burdening system for SMEs:

He suggested principles based approach to corporate governance provision, rather than a rule driven. That is, less legal influence and more credence given to cultural imperatives, economic theory and political constructs that informs and shape corporate governance.

- He believes in the development of a two-step governance system; one for large firms and one for SMEs. That is, a governance arrangement better attuned to the market place which it serves. A simple, principle based governance for SMEs should be allowed that can 'weave' its way up to large firms, rather than a continuation of the trickle down approach from large firms to SMEs.
- Specific and simple SME governance arrangements that reflect their particular form and architecture. These forms include the predominance of family based firms with a strong crossover between managers and owners. This provision would recognize the largely fictional notion of separation that is, in fact, more appropriate for large and listed firms. Furthermore, studies have found that SMEs do not necessarily benefit from applying the same CG framework as that of the listed companies (Yacuzzi, 2005; Cowling, 2003, Liang & Li, 1999)
- The possibilities of recognizing a form of hybrid partnership- company arrangement for SMEs. This can be achieved by a separate set of rules, or by specific legislation that recognizes that at the margins, the partnership form and the corporate model do in fact overlap. Rather than the complex set of rules that are theoretically applicable, but badly fitted in practice to SMEs, there should be a differentiated approach that is informed by the basic, but imperative notion, of differential architecture. The domain occupied by SMEs is unique: not part of formless arrangement which bundles all firms together in an apparently unproblematic way.

According to Clarke (2006), these suggestions are in no way exhaustive, but it would be salient to finally recognize the distinct needs and interests of SMEs in an increasingly competitive environment. In addition, study by Mahmood (2008) suggested the some recommendations/steps towards development of a good framework for SMEs in Pakistan.

The study suggested that the process should be conducted through establishment of a special committee or task force consisting of representatives from SME Chamber and Securities Exchange Commission. It is also 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. The study further commented that training workshops should be organized for all stakeholders including the owners of SMEs to educate the SMEs of the CG framework developed.

There were suggestions that the Code be based on the following principles:

- Self-regulation i.e. voluntary to adopt rather than enforced
- Incorporates the particular needs of SMEs
- Flexible so that it can be adapted to the heterogeneous sectors and sizes of SMEs
- Not complicated and easy understand for business owners
- Should be incentives based such as providing tax rebates. This may even encourage informal enterprises to adopt the CG system if tax incentives are provided by Government.

Other regulations should be amended to make them compatible with the Code in order to avoid regulatory burden and duplication. To begin with, many problems are already in existence in adopting CG in listed companies, to name a few; lack of sincerity in the enforcement at board level is one of the many problems. In other words, there is lack of self-regulation by the board to ensure good governance. Composition of audit committee (AC) members are not all independent in most companies whereas independence is a very element to support the effectiveness of internal audit functions (Barac and Staden, 2009). Audit Committee is also responsible to recruit the Chief Audit Executive, ensure adequate resources of internal audit function as well as approving internal audit plan and report (FRC, 2012)

One other main issue faced in ensuring good governance is the lack of good surveillance and supervision by regulators, for example, SC. Finally, we are facing a problem of lack of qualified independent directors who really understands the business and lack of good quality internal auditors. It is not surprising that these problems will be more evident in SMEs which are trying to adopt GRC.

So far this paper has summarized findings of past literatures on CG and SMEs and found that CG does benefit SMEs however, not without adjusting the code to suit the requirements of SMEs which are significantly different from that of listed companies. To date, the MCCG are only applicable for listed companies and these set of codes may be too burdensome on SMEs. It is also noted that internal audit function is important in the success of SMEs.

6. Conclusion

SMEs are important in facilitating economic activities and in providing employment especially in the developing countries. Good corporate governance enhances competitiveness of SMEs and is crucial for the continued development of SMEs. Based on review of extant literatures, it can be argued that SMEs do not necessarily benefit from applying the same CG framework as that of the listed companies. Literatures also found that SMEs who are closely held may not hinder productivity. This gives rise to the argument that a custom made framework may be more beneficial for SMEs, the framework should be flexible and dynamic and the process of developing the framework should be participatory; one can argue that one size does not fit all. This is similar to principal of having a separate set of IFRSs for SMEs.

However, in order for the development of a separate framework for SMEs to be successful, more parties should be involved especially the regulators. Guidance should be provided to SMEs on issues related to corporate governance. In addition, regulators should take up the responsibility to create greater awareness among SMEs on the importance of good governance practices, perhaps through incentive system via the tax structure or award recognition for good governance by SMEs. Currently, there is still very limited awareness among SMEs on the importance of adopting good corporate governance and one of the major obstacles is high cost involved in implementing corporate governance, hence the aversion in adoption among SMEs.

SMEs are driving the economies of the developing nations, it is therefore inevitable that these enterprises have good governance in order to stay competitive and continue to grow. Awareness and commitment by all parties involved are crucial for the success of implementing good governance in SMEs.

7. Limitations and Area for further research

This paper is solely based on review of extant literatures, no empirical evidence was deduced. Based on the limited amount of time available, it was found that there are very limited empirical investigation on research of corporate governance of SMEs in developing countries especially Malaysia. Further research should be performed to gain empirical evidence on whether a separate corporate governance framework is preferred by SMEs in Malaysia. Probably a quantitative research can be conducted via distribution of survey questionnaires to collect primary data from samples of SMEs in Malaysia on their opinion with regards to whether a different set of framework is practical. With the availability of more empirical evidence on researches on governance in SMEs in Malaysia, it may have profound implications on a number of groups namely, the institutional investors, regulators as well as Government of Malaysia in the hope that all these parties are aware of the importance of putting more emphasis on developing SMEs of the developing nation via good governance structure.

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