

GOVERNANCE AND
REGULATIONS:
CONTEMPORARY ISSUES

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GOVERNANCE AND REGULATIONS: CONTEMPORARY ISSUES

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INTRODUCTION TO CSEF 99

The Emerald book series *Contemporary Issues in Economic and Financial Analysis special edition CSEF 99* includes studies on different topical issues on Contemporary Issues in Governance and Regulations, by authors invited from various universities and institutions. The chapters are a mix of discussion-based studies and empirical research studies aimed at understanding particular aspects of governance and regulations. Some refer to a particular country specifically Malta, Indonesia, and India, and others are more generic and/or European.

The first chapter relates to small family-owned firms and the challenges of corporate governance. This form of business is dominant globally; however, research focusing on its governance has been largely overlooked. The author discusses the benefits of sound governance in these types of enterprises, the significant governance issues, and unique concerns they face and what can be done to help mitigate them.

The next chapter gives a credit institution's perspective of how to manage conduct risk in the boardroom. The author discusses the issues which led to misconduct and hefty fines on credit institutions in recent years, which she labels as "conduct risk" and the regulatory spotlight on it. She notes that this risk continues to top the regulators' agenda in view of its seriousness and considers the role of the board in managing it, while elaborating on the importance of board evaluations in this respect.

In the third chapter the author examines and discusses the implications of the developments of the regulation and governance of financial advice in the context of MiFID II. He specifically looks at regulatory issues concerning the definition, suitability, and delivery of advice; the affordability of advice; and the challenges and opportunities facing the advice sector as a result of the increasing use of technology in the financial services sector. In particular, it considers the example of the UK, and issues this raises for the implementation of recent European regulatory reforms.

The authors of the fourth chapter lay down a study on the barriers to the development of Maltese cooperatives. They highlight the significant barriers after carrying out a research using semi-structured interviews with a selection

of 18 representatives of the small current Maltese cooperative movement, most of whom are active either in individual cooperatives (16) and/or in the cooperative institutions (5). They conclude with the identification of significant barriers and targeted actions which may be recommended and taken so as to reduce, if not eliminate, these barriers and thereby help the Maltese cooperative movement flourish.

In the fifth chapter, the author sheds light on the role of corporate governance in the determination of cash holdings and examines how ownership structure, board, and audit-related attributes (used as proxies for the nature of corporate governance) impact cash holdings in the context of an emerging economy, like India. He employs four different empirical measures of cash and liquidity and 24 structural indicators of corporate governance. Using principal component analysis, he explores the dimensions of corporate governance. Thereafter, using a sample of 58 top-listed companies, he delves into understanding the association between cash holdings (the dependent variable) and corporate governance.

The authors of the sixth look at the relationship between good governance and trust in government. They use data on government trust across a sample of 29 European countries over the period 2004–2015, as well as six different aspects of governance as captured by the Worldwide Governance Indicators. Moreover, the authors also seek to compare the relative importance of governance issues to measures of economic prosperity, including real GDP growth and income inequality.

In the seventh the author looks at takeover bids as an important debate in European Law and corporate governance. She looks at the risk of a takeover bid and of a consequent change in company control. Moreover, she analyzes the European rules on takeover bids, and highlights certain national options for implementing the Directive and discusses the revisions currently being proposed by the European Commission and the European Parliament.

The author of the eighth discusses the need for change in the doctrine of “utmost good faith” and lays-out the drivers behind these changes and the commensurate effect on the practice of insurance. The author delves into case studies, practices, and literature and traces back to the origins of this long-standing principle and later discusses the development and drivers leading to reform of this doctrine.

In the ninth, the authors empirically investigated the importance of the Audit Statement of Opinion in the Final Audit Report to ensure good corporate governance and to reduce earnings management and ensure accurately informed corporate decisions. To do this they used a self-administered survey purposely designed for the study and administered it to a population of

100 accounting managers and financial managers of manufacture companies listed on Bursa Efek Indonesia during 2015.

The authors in the next chapter evaluated whether the launch of a European Deposit Insurance Scheme (EDIS) as a single deposit guarantee in Europe, which is now being recognized as one of the three main pillars, together with the single supervisory and resolution mechanisms, would enhance depositors' protection in times of banking crisis and also reinforce financial stability in the European Union as part of the proposed Banking Union. They carried this out by making reference to academic literature and also recent EDIS political dossier to outline the developments.

In the next chapter the author introduces the readers to product intervention power under the markets in financial instruments regulation and packaged retail and insurance-based investment products regulation for all EU Member States and provides an overview of supervisory measures, that is, the scope of the product intervention power, criteria, factors, and risks, which has to be taken into consideration when using this regulator's tool. She notes that this gives National Competent Authorities, European Securities and Markets Authority, and European Banking Authority powers to monitor financial products (and services) under their supervision and to "temporarily" prohibit or restrict the marketing, distribution, or sale of certain financial instruments or to intervene in relation to certain financial activities or practice.

The author of the twelfth chapter discusses issues and developments that relate to the teaching of bank regulation in tertiary institutions. It looks at how course content, teaching texts, and methodology can become subject to issues like specific historical, and jurisdictional, cultures and contexts for the discipline. It considers how economic and political approaches impact such teaching. How banking regulation tools are used, and course structures are built, and shows that these are matters which impinge on the type of trained bank personnel who later eventually leave academia and end up working on regulatory or compliance matters.

In the penultimate chapter, the author highlights the most prominent theories surrounding the cultural framework people operate in when they are involved in the risk management process, which is an important function in the governance structure of a firm. The focus is on how culture, gender differences, and values affect the way people take decisions when faced with risk. The author critically examines literature carried out in the realm of sociology and psychology in organizations and discusses the effect these have on the risk management process. She discusses the effect of sociological factors on the governance of an organization and links this to one of the internal control processes, that is, the risk management process.

In the final chapter, the author explores how mandatory transparency affects financial institutions' activity and whether it performs its function efficiently. She highlights that financial markets have recently become subject to new regulations requiring transparency such as, the EU directives MIFID II or Solvency II. She argues that what is expanding is not just the applicability of the principle as such, but the scope of issues which are affected by transparency, that is, remuneration or conflict of interests. Moreover, she continues by noting that in the light of these regulations it may seem that transparency simply became a sole legislative measure assuring values such as consumer protection, market stability or – most of all – high-quality governance. However, transparency contributes to the quality of governance in a several different ways, although its implementation must meet certain standards if it is to produce the desired results, especially when it comes to financial institutions.

SMALL FAMILY-OWNED FIRMS: THE CHALLENGES OF CORPORATE GOVERNANCE

Philip M. Beattie

ABSTRACT

Despite being the dominant form of business globally, it is widely recognised that research focused on the governance of small family-owned entities has been largely overlooked. The benefits of sound governance practices are deemed salutary for small business prosperity; however, these enterprises are confronted with significant governance issues and unique concerns of their own. One particular issue concerns the compliance costs of governance for family-owned businesses and the extent to which the regulatory environment actually encourages an evolution towards an improvement in governance practices in smaller businesses. Reconciling decision speed, flexibility and entrepreneurial innovation to necessary enhanced governance practices and procedures remains problematic. It is argued that a proper balance between the costs and benefits of proper governance codes and structures for smaller firms can only be achieved with a strong emphasis on flexibility to take account of myriad types of governance requirements of firms. This would entail the development of an evolutionary view

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of corporate governance implementation, one which mirrors the process of delegation of the entrepreneurial function to company boards and management. This would lend support to the view that there is no universal 'best way' for all firms at all stages of the business life cycle. In this respect, the application of the principles of subsidiarity and incentives plays an important role.

Keywords: Governance compliance costs; flexibility; family-owned firms; family governance; subsidiarity

1. INTRODUCTION

It could be construed as reasonable to assume that a substantial body of research on governance aspects of small family-owned firms exists. Yet despite such firms constituting the dominant form of business around the world, the opposite appears to be the case. [Mallin \(2013\)](#) observes that while the family-owned business encompasses sole traders, partnerships, private companies and public companies, family ownership is prevalent amongst both privately held and publicly traded firms across the globe. For his part [Tricker's \(2015\)](#) assertion that the governance of private companies and other corporate entities has been overlooked appears difficult to refute, regardless of whether we define corporate governance from an operational, relationship, stakeholder, financial economics or societal perspective. [Klein \(1999\)](#) places emphasis on the provision of capital to small entrepreneurial ventures as a particularly undeveloped research area, while [Wellalage and Locke \(2011\)](#) contend that little empirical work focuses on how corporate governance impacts agency costs for smaller business. These are just two areas of small firm governance aspects that clearly require further investigation. The difficulty of securing a generic definition of a family firm that translates across all societies ([Carney, 2005](#)) compounds the research problem.

An interesting paper by [Durdan and Pech \(2006\)](#) points to the risks that ever more prescriptive, legal and regulatory approaches to corporate governance may stifle management in relation to an agile and rapid response to external pressures. With reference to increased levels of regulatory governance compliance, these authors have coined the term 'decision speed bumps' which serve to dilute and divert managerial efforts. Support for this stance may be found in the literature that highlights potential costs in relation to excessive levels of regulation (e.g. [Koedijk & Kremers, 1996](#);

Guasch & Hahn, 1999). While these papers focus primarily on firms that are not in the entrepreneurial stage of the business life cycle, it may be deduced that the difficulties and costs they highlight are applicable in the case of smaller businesses, possibly more so.

Yet in an age where there appears to be greater convergence towards not just continent-wide governance regulation (e.g., Collier & Zaman, 2005; Neville, 2013) but a global governance approach, it is legitimate to question where all this leaves small family firms facing significant and unique governance issues of their own. There appears to be no dispute that improved corporate governance is essential to ensure business stability and sustainable economic development. Yet it does not appear surprising that small business owners shy away from the subject of corporate governance (Raiz, 2014).

This chapter provides an overview of the case for improved governance practices for small family-owned firms by looking at the causes of entrepreneurial failure. It further highlights the difficulties and challenges these firms face when confronted with governance implementation mechanisms. While the tendency to trivialise or underestimate the costs involved in relation to governance compliance mechanisms is avoided, it is recognised that certain governance compliance costs are unavoidable for entrepreneurial family firms, as for all businesses. Time spent on governance compliance by employers and managers is one such example. This contribution also presents arguments in favour of an approach based on flexibility and formal structures that avoid a 'one size fits all' mentality in relation to small family-owned firms. The importance of state incentives such as tax benefits that could potentially assist with governance implementation within the small business sector is also referred to.

The chapter concludes by highlighting the importance of the application of the principle of subsidiarity as an important ingredient of corporate governance for small business sustainability.

2. ENTREPRENEURIAL FAILURE AND THE CASE FOR SOUND GOVERNANCE

Experts at Dun and Bradstreet have identified the causes of business failure as being generally due to what they term 'bad management', citing incompetence, lack of managerial experience, unbalanced experience, business neglect and fraud or disaster as the principal causes of entrepreneurial failure (Siropolis, 1994). It may be argued, however, that bad or inexistent governance provides an impetus to bad management and vice versa. Using Tricker's

(2015, op. cit.) crucial distinction between governance and management is important in this respect: governance covers the work of the board of directors or other governing body within the business, ensuring that the business is well run and run in the right direction, while management relates strictly to the work of the executive management team, that is the actual running of the business. With this perspective in mind, one can analyse the most common stumbling blocks that firms fall prey to, resulting in business failure and which the small business owner must circumvent in order to succeed.

Halloran (1991) highlights 20 entrepreneurial pitfalls in his work; I argue that at least 14 of these pitfalls could be avoided through sound and effective governance mechanisms in place.

Table 1 highlights my comments as to how proper corporate governance mechanisms could mitigate or contain the causes of entrepreneurial failure this author has cited.

An objection may be raised that some of the highlighted causes of entrepreneurial failure cited in Table 1 relate to areas proper to management rather than governance. It is undeniable, however, that corporate governance theory focuses on the board of directors' role as a monitor of management. This is also confirmed by the definitional distinction between governance and management to which Tricker alludes (2015, op. cit.).

Additionally, there is scope for arguing that firms with different ownership structures require boards to play different roles (Neville, 2013). In terms of family-owned firms, there is evidence to show that they use substantially different corporate governance structures from non-family firms leading to performance differentials between the two firm structures. This may also suggest that family control creates rather than negates agency costs (Bartholomeusz & Tanewski, 2006). As the International Finance Corporation *Family Business Governance Handbook* (2011) makes clear:

Family businesses can improve their odds of survival by setting the right governance structures in place and by starting the educational process of the subsequent generations in this area as soon as possible. (p. 11)

Many family businesses do not pay sufficient attention to key strategic areas such as: CEO and other key management position's succession planning, family member employment within the company and attracting and retaining skilled outside managers. Delaying or ignoring such important strategic decisions could lead to business failure in any family business. (p. 14)

The foregoing suggests that sound and proper governance mechanisms are as applicable and useful for small family businesses as they are for the larger corporate organisations. The conundrum that needs to be resolved in the

Table 1. Entrepreneurial Pitfalls of Running a Small Business.

Halloran's Fatal Entrepreneurial Pitfalls	Explanation	How Proper Governance Could Avoid the Pitfall
1. Using a business plan not tailored to the entrepreneur	The entrepreneur relies on a business plan that is not his own	Business planning and strategy formulation require the assistance of a board structure of some kind in place or at least the assistance of an external independent director
2. Using inaccurate sales forecasts	Relying on inaccurate business information	The implication that improving management and marketing skills of directors and executive managers is a task proper to governance, primarily
3. Short-sighted financing arrangements	Securing a short-sighted loan due to improper planning of entrepreneurial finance needs	An effective board and/or advisory committee structure staffed by competent professionals with proper financial management skills can mitigate this difficulty
4. Missing the target market	Selling output to the wrong market	Properly identifying the target market for the entrepreneur ought to break down the overall market for the goods or services sold to those market segments that utilize them most. An effective board structure or advisory committee staffed by individuals with experience in marketing matters would prove invaluable in terms of marketing plan formulation
5. Buying costly and ineffective advertising	Avoiding owner participation in advertising and promotion	Proper governance mechanisms could ensure that an owner-director ought not abdicate his role in decision making. The importance of job descriptions outlining specific responsibilities for personnel, including the owner-manager is an important governance contribution here
6. Using inappropriate selling techniques	Forgetting that the entrepreneur needs to sell to the customer's needs not the entrepreneur's	While product knowledge on the art of the entrepreneur is essential, the design of effective sales plans ought to fall within the ambit of governance structures such as advisory boards or formal boards which include persons skilled in determining the sales training shortfalls within the family concern

Table 1. (Continued)

Halloran's Fatal Entrepreneurial Pitfalls	Explanation	How Proper Governance Could Avoid the Pitfall
7. Setting prices that hold down profits	Failing to protect the profit margin by competing with a discounter	Price setting is an essential component of business and market strategizing. If the appropriate governance board or advisory committee structures are in place, the formulation of price-setting as part of the overall firm strategy could avoid costly errors
8. Inconsistent management	Poor hiring policies, no flexibility in management and poor employee motivation	While generally acknowledged that management (and other) personnel recruitment for the small business is hampered by a relative lack of capital resources, the small business can create a work environment that allows employees to be rewarded and recognized for business success attained. In this respect, the input of an advisory board, as well the formulation of a family-owned dedicated compensation package for employees as part of the firm's governance charter should be of benefit
9. Living off cash flow rather than profits	Small business owners living high on the hog for a short period of time	Detailed cash flow planning is required; a governance mechanism that could assist in this area is the Family Charter which will outline policies for correct fund allocation, including owner-manager compensation. Additionally the firm's Advisory Board should monitor fund allocation by providing input towards the formulation of cash-flow plans and their monitoring
10. Letting the firm's external accountant run the business	Entrepreneurs making financial decisions without financial knowledge	An important governance consideration here is the use of job specifications that enable the everyday bookkeeping duties to remain within the hands of the owner. This would require an understanding of basic bookkeeping and is a skill that owner-managers could master through internal or in-house training or through the induction of an experienced advisor. Again, a governance charter for small firms should make specific reference to such mechanisms

<p>11. Ineffective inventory planning</p>	<p>Poor purchase planning policies that fail to account for profit maximization</p>	<p>Input for the creation of effective purchase plans ought to come from an experienced external director, or the firm's advisory board. Incorporating the taking of a proper ending inventory at its proper value at regular intervals should also be formulated within the job specifications for owner-managers or the relevant employee(s). The financial knowledge required would need to be attained by in-house training or regular skills updating for family-owned board members</p> <p>This highlights the importance of devising a delegation system among personnel that assures assignments' completion. This would require effective training to be built into the system. Job descriptions that cater for overlapping of roles and organisation charts showing where employees fit into the business are critical governance mechanisms that play a pivotal role</p> <p>Expansion planning is central to the role fulfilled by a company board of directors or advisory committee with at least one or two persons with experience in business strategy</p>
<p>12. Chaotic management</p>	<p>Forgetting basic management principles and failure to plan the future direction and goals of the business</p>	<p>The role of the Family Board external to the business plays a very important part in terms of the consideration of retirement plans for family-owned concerns. This is especially relevant in relation to succession planning</p>
<p>13. Expanding for the wrong reasons</p>	<p>Failure to understand that business expansion can only be done in consideration of timing, debt and demand, and not just personal desires of the firm's owner-manager(s)</p>	<p>The role of the Family Board external to the business plays a very important part in terms of the consideration of retirement plans for family-owned concerns. This is especially relevant in relation to succession planning</p>
<p>14. Believing you will work forever</p>	<p>Waiting too long to retire and plan for succession or selling out</p>	<p>The role of the Family Board external to the business plays a very important part in terms of the consideration of retirement plans for family-owned concerns. This is especially relevant in relation to succession planning</p>

Source: Adapted from Halloran (1991).

literature – insufficiently to date in my view – is the way this may be achieved within the small family-owned firm which will enable manageable costs of compliance, as well as effective and efficient governance codes, practices and other mechanisms that do not inhibit or stifle the firm’s ability to take speedy decisions, while operating flexibly and innovatively.

3. THE DIFFICULTIES AND COMPLIANCE COSTS OF SOUND GOVERNANCE

Notwithstanding the undoubted benefits that proper governance brings to the entrepreneurial firm and to small business in general, myriad difficulties present themselves when it comes to the implementation of governance mechanisms. There is a recognition that guidelines and in some cases legislation based on financial aspects of the large corporate organisation may be ineffective in different types of organisations and that effective governance can be reached through different paths (Kane, 2007).

The costs of governance implementation constitute a major factor in a governance framework that highlights the importance of business context and constitute the values of inputs to corporate governance. In a general sense, these include the systemic or direct costs of governance such as new regulations leading to increased business expenditure on directors’ insurance policies for example, as well as less explicit costs. Examples of the latter include the impact of governance practices on the strategic opportunities of the firm and its ability to exploit business opportunities, in addition to proprietary and reputational costs (Kane, 2007, op. cit.).

Additionally, when discussing the governance scenario in New Zealand, it has been observed that:

[...] the regulatory environment, tax anomalies and the cost of information do not encourage an evolution towards better governance in smaller businesses. There is a need to develop a corporate governance code for smaller firms that is flexible enough to take account of the different types of governance needs of firms at different stages in their life cycle and the nature of the business. (Wellalage & Locke, 2011, op. cit.)

In this context it is worth noting the distinction drawn by the United Kingdom’s Institute of Directors between corporate governance principles (referred to as Phase 1 Principles) for all unlisted firms as opposed to Phase 2 principles applicable to large and/or more complex unlisted companies (Tricker, 2015, op. cit.).

One of these Phase 1 principles (Principle 9) relates to the need for family-controlled firms to establish family governance mechanisms that promote coordination and mutual understanding among family members, as well as the organisation of the relationship between family governance and corporate governance. While the recognition of the distinction between firms at different stages of development and with different control structures is deemed positive, this also raises the issues of the costs arising with family – rather than corporate – governance such as the establishment of what [Tricker \(2015, op. cit.\)](#) calls the ‘family council’. It follows that, despite the benefits of structured family governance, costs relating to governance for family controlled firms are twofold, corporate-induced and family-induced.

Again, the business life cycle is much wider in scope than the evolution from an unlisted firm to one which – albeit unlisted – is larger and/or more complex. This notwithstanding, as [Filatotchev \(Kane 2007, op. cit.\)](#) notes:

It is never too early to be thinking about corporate governance. It is not just about what happens on large Boards, it is about good business practices at all levels. Companies should be transparent and accountable even when they are privately owned. A firm that is at the beginning of their life cycle may be growing fast in a very dynamic environment. It might quickly outgrow the capacity and knowledge of the original founder. Then they would need to look outside for someone who has experience in managing a high growth business. This is, in fact, putting in the first governance structures in place. (p. 60)

The way in which the foregoing may be achieved is fraught with difficulties, not least cost and expense challenges. Evidence suggests that agency costs vary with leverage, the life of the business and its size ([Wellalage & Locke, 2011, op. cit.](#)). These are rendered more complex by certain agency problems that are unique to family firms, such as the conflict of interest that exists between family shareholders and the family at large, deemed to be the fourth classic agency problem unique to family firms ([Villalonga, Amit, Trujillo, & Guzman, 2015](#)). The foregoing is additional to the other three agency problems that family-owned businesses are exposed to, namely: (i) the conflict of interest between the business shareholders and firm managers, (ii) the conflict between controlling family shareholders and non-controlling shareholders and (iii) that between shareholders and creditors.

It is hence no surprise to discover that small family-owned firms are managed by only one or two persons, mainly the owners and/or managers, who make all the critical decisions on finance, accounting, personnel, purchasing and marketing without the aid of internal specialists and with specific knowledge in only one or two areas at most ([Heenetigala, Armstrong, & Clarke, 2011](#)). Referring to the situation in Australia, these authors state:

Compliance with legal obligations were managed by accountants and lawyers. Small businesses were apathetic in regard to complying with best practice governance. Corporate governance regulation that applied to all businesses was written with big business in mind, in language that was directed to accountants and lawyers and not understood by the small businesses. Therefore they found it difficult to understand corporate governance legislation. (Heenetigala et al., 2011, p. 50)

It should hence be clear that the complexity and relative obscurity of language used in governance legislation provides another unique cost faced by small family businesses, the latter unable to afford the cost of internal specialists to interpret regulatory legislation. The notion has been advanced that entrepreneurs have an innate tendency to 'buck the system' (Raiz, 2014, op. cit.), in that their nature is such that they will resist the implementation of systems and processes. Allon Raiz adds that many small business owners in fact open their own businesses precisely to escape the strait jacket that systems may create.

If larger firms operating in rapidly changing and highly competitive markets face regulatory speed bumps with managers distracted by issues surrounding an organisation's compliance with increasing levels of corporate governance regulation (Durden & Pech, 2006, op. cit.), it may be deduced that compliance-related costs and problems for owner-managed firms and family-owned small businesses generally, ought not to be trivialised.

A global survey developed by KPMG and executed by Forbes Insights in September 2015 completed by 154 private company directors reveals interesting demographics as well as interesting results (Forbes Insights, 2015). The demographics of survey respondents reveal the following:

- 100% of respondents were serving as a director for at least one private (non-public) company.
- Privately-funded start-up firms represented 38% of the survey sample interviewed.
- Entrepreneur- or family-owned business represented 32% of the survey sample interviewed.
- Small businesses thus constituted at least 70% of the survey sample.

It transpires that the greatest current or ongoing governance challenges faced by survey respondents resulted in the following:

- Risk management oversight: 27%.
- Assessing innovation and emerging competition: 25%.
- Establishing or confirming company strategy: 23%.

- Regulatory compliance: 21%.
- Leadership succession: 18%.
- Global compliance: 17%.
- Board effectiveness: 17%.
- Director time and workload: 16%.
- Overreliance on management's information: 13%.
- Divided ownership group: 10%.

Furthermore, for survey respondents with a turnover of less than \$500 million, 18% of this sub-sample confirmed that regulatory compliance was deemed the major governance challenge confronted by respondents, while leadership succession was deemed by 29% as their greatest ongoing challenge. For this sub-sample, 29% also deemed establishing or confirming company strategy as the major governance challenge that needed to be tackled. While regulatory compliance for the largest firms is understandably deemed as their major challenge by almost a quarter of those surveyed, it is noteworthy that almost 20% of smaller business respondents cited regulatory compliance as their greatest governance challenge. This suggests that the gap between governance compliance difficulties experienced by the largest organisationally complex firms and smaller businesses – whose principal-agent distinction is much less clear and/or minimal – may not be as large as may be imagined. Raiz (2014, op. cit.) goes as far as asserting that large companies benefit more from improved corporate governance than small companies do. This is not an uncontested view. By contrast it has been argued that family-owned firms have governance advantages in terms of their propensities for value creation (Carney, 2005, op. cit.).

Carney's research draws upon the resource-based view of the firm and advances the argument that family-controlled firms' competitive advantage is imputed to their system of corporate governance. He illustrates his argument by citing the experience of family-controlled firms in emerging markets by way of example. What might be construed as the mainstream of thought in this specific area would deny Carney's contention, and argue rather that there are:

[...] severe social and economic constraints on families that limit their growth and longevity. Many agency theorists suggest that large family firms are structured to effect value appropriation rather than value creation. (Carney, 2005, op. cit., p. 260)

To these criticisms Carney replies:

It is true that the vast majority of family enterprises remain small. The incidence of family firms in fields such as franchising, trading and small-scale manufacturing suggests that this mode of governance has parsimony and efficiency advantages in numerous industries

and at certain stages of the value chain. The geographical ubiquity of the family firm is suggestive of universal governance in small-scale production units relative to other governance modes. However, the growth and dominance of business groups in emerging markets suggest that family firms are capable of transcending the size constraint implied by the “thick social wall” thesis, and that some aspects of family firm advantage are characterized by scale economies that drive firm growth. It is probable that the efficiency advantages of family governance diminish with large firm size. (Carney, 2005, op. cit., p. 260)

While Carney’s defence has merit, it fails to explain the relatively high incidence of small family business failures imputed to poor governance practices not just in emerging markets, but globally. More importantly it appears to implicitly avoid addressing the need for enhanced governance procedures and structures within family enterprises, given the unique agency problems they face relative to other business types.

4. APPROACHES TO SMALL BUSINESS GOVERNANCE: CREATIVITY, FLEXIBILITY AND THE EVOLUTIONARY PROCESS

The importance of enabling the establishment of *Family Councils* for family enterprises has been highlighted by a number of authors in the area (Davis, 2007; Tricker, 2015, op. cit.; Villalonga et al., 2015, op. cit., among others). This body is the representative work group that organises meetings and education for the family, drafts regulations, policies and statements for their discussion and approval by the wider family assembly and is invariably delegated by the latter body to reach decisions on its behalf. The objective here is for the family council to coordinate with the family enterprise’s board in order to align the objectives of the family and the shareholders as much as possible. This council has the added task of subjecting those family decisions and policies that concern the firm such as family member employment and compensation packages to the board’s approval (Villalonga et al., 2015, op. cit.).

While the constitution of this council can clearly counteract critical agency problems that plague family enterprises, its effectiveness is conditional on having a strong board within the enterprise which can counterbalance the interests of the family at large with those of shareholders, both family and non-family. Indeed, in the absence of a strong board of directors, the authors make clear that family governance can exacerbate agency problems, by formalizing and legitimizing policies that may benefit family outsiders at the expense of the firm and its shareholders.

Alternative or additional approaches cited by these authors also include a Shareholders' Council and a Family Constitution. In sum, these family governance mechanisms constitute a creative way to approach the problems relating to family governance, as it impinges on the family enterprise's governance methods, although as [Ward \(2010\)](#) observes, the process of such mechanisms supersedes their actual content in importance as a critical success factor in family governance.

The need for a flexible approach to small firm governance is also an important factor that should be addressed. If there is truth to the assertion that a one-size-fits-all board is questionable within the ambit of business concerns with different ownership and management structures ([Neville, 2013](#), op. cit.), it follows that norms, patterns and traditions of business behaviour that have evolved in jurisdictions with different

Economic, business, cultural and legislative structures should not be based on a single model as the Preda Report issued by Italy's Stock Exchange Committee for the Corporate Governance of Listed Companies (Preda, 1999) makes clear. If this assertion rightly applies to listed firms, it should also apply in equal measure to small family-owned enterprises, given the unique set of governance circumstances pertaining to these firms.

In this context, what critically matters for small family firms is flexibility in both the content and, especially, in the process of corporate governance mechanisms with due regard to consistency of approach and fairness of treatment to all the parties involved. This would suggest:

- A recognition that the governance implementation mechanisms must mirror the evolution of the family enterprise as it passes through various stages of its development and growth; governance practices must be geared to the recognition that accountability and transparency should not be considered as uniform in magnitude as the complexity of the firm's business procedures unfold over time.
- An emphasis on organisational design, management and motivation in lieu of increasing regulations, excessively details codes of practice and 'costly template compliance measures' ([Durdin & Pech, 2006](#), op. cit., p. 91).
- A core set of governance principles that may be attained through different approaches in style and method.

While there are no illusions that attaining such objectives is a simple task in the current globalised convergence environment, the tasks of creating simple internal polices, separating the roles and responsibilities of shareholder, director and manager thus ensuring effective division of labour, and the

creation of a fledgling advisory committee or board structure are not beyond the capabilities of the entrepreneurial family business.

In practice, this translates into attaining forms of best practice through a number of sequential steps, among which figure the following:

- Finding the time to map the current business structure and visualizing how it will grow.
- Finding time to map the enterprise's current internal policies and processes and formulating them.
- Establishing an advisory board or embarking on a gradual process of including experienced and qualified external members within the board structure.
- Introducing a code of conduct, however simplified initially.
- Setting simple goals and a basic strategy to fulfil them.
- Planning for consistent financial reporting.
- Incorporating unexpected scenarios within the businesses' plans.
- Incorporating the firm's compensation and benefits schemes.
- Finding the time to monitor governance legislation and sectoral governance trends.

5. APPROACHES TO SMALL BUSINESS GOVERNANCE: SUBSIDIARITY AND INCENTIVES

The principle of subsidiarity has an important role to play in this regard. While there seems to be very little literature on how this principle may be adapted towards governance mechanisms for small business, this topic warrants a potentially important avenue for future research in the area of firm governance. [Horvat \(2013\)](#) defines this principle succinctly:

By this principle, a social unit should have recourse to a higher unit or authority only in those matters it is unable to handle. The higher societies are subsidiary to the lesser and exist to serve them [...] The State should thus leave to the family those tasks that are proper to it ... National, state or local professional organisations should take care of the matters proper to each. (p. 176)

I argue that the potential is there for transposing this principle to the sphere of corporate governance through the actions of governing layers of intermediary associations that lie between the family business concern and the State. [Argandona \(2011, chapter 9\)](#) notes that the application of the subsidiarity principle has interesting aspects and implications for corporations.

He focuses on an explanation of the definition and role of an organisation, which he views as a natural example of the role of subsidiarity in governance. Argandona's contribution thus constitutes an approximation to the development of a model of governance based on subsidiarity grounded in the theory of the firm and the theory of human action. In the context of the small family business enterprise, I would venture to suggest the following considerations in terms of how subsidiarity in governance may be applied in practice:

- Researching the feasibility of devolving the establishment of governance codes, principles, structures and mechanisms to trade and professional associations, municipal councils and voluntary associations of a civic nature within the firm's locality.
- Enacting legislation by which intermediary bodies both private and public would be formally recognised or sanctioned to offer practical advice and assistance towards small family business concerns on a regional or municipal basis with pilot schemes that are subject to State scrutiny and amendments as necessary.
- Incentivising trade and other professional bodies within the private sector with tax credits or other tax benefits on any taxable income they generate subject to their provision of practical consulting assistance to small family-controlled businesses at minimum or at no cost.
- Government validation of business educational courses offered by private firms, professional bodies and trade associations for staff employed within small business concerns as State-sanctioned recognised routes to employment within the labour market, subject to minimum standards of education and training.
- Extending special tax benefits to small businesses who disburse company funds to organise in-house management training to company directors, management and personnel or who formally adopt advisory or other board structures.
- Formal State recognition and/or fiscal incentives for small firms that officially constitute family councils and related family governance mechanisms.

A related area that blends governance with the principle of subsidiarity relates to employee participation in corporate governance. Work undertaken in this area focuses on the employee's ability to participate in an adequate manner in the governance of his workplace, particularly in legal jurisdictions with an employee-centred approach to governance (Lower, 2005). Employee governance is rare in advanced market economies due to what may be termed its relative inefficiency compared with shareholder governance. The debate

over the alleged impracticality of this ideal is hampered by an inadequate conception of employee governance that insufficiently accounts for the difference between employees and shareholders. This does not, however, eliminate the possibility of suggesting new strategies for strengthening the role of employees in corporate governance (Boatright, 2004).

In the small family-controlled business perspective, there are difficulties in achieving such an ideal, especially for the smaller owner-managed firms. These obstacles are, however, not insurmountable in view of the widely recognised tendency for greater employer-loyalty by the employees in family firms (particularly in crisis situations), relative to employees in non-family firms. The closeness in daily work operations between family owner-managers and their employees in small firms also helps to further an environment where the exchange of views and ideas is facilitated. In addition, there are clear organisational benefits to be gained from mechanisms of employee consultation and participation for small businesses, however, rudimentary. As Lower (2005, *op. cit.*) observes, it would not be appropriate for all the details of employee participation in workplace issues to be formally specified, as what is possible and appropriate is sensitive to the specific business context as well as to its stage of development, among other factors.

6. SUMMARY AND CONCLUSIONS

The corporate governance issues faced by small family-owned businesses are numerous and pose several challenges for these firms in terms of their capacity to survive, much less grow. There is a clear need for further research in this area in terms of the implications of governance compliance on the operations, outlook and progression of the small family business. In this respect more work is needed to highlight how enhanced governance may be achieved cost-effectively for such firms rather than focusing exclusively on the benefits of sound governance mechanisms.

The unique governance issues such firms face, particularly those relating to agency problems and compliance costs, warrant particular attention. The governance compliance costs faced by these businesses are significant and cannot be under-stated. Securing an appropriate balance between these costs and maintaining these firms entrepreneurial character poses significant challenges to regulators, legislators and researchers alike.

For small firms, the required direction with an emphasis on flexible mechanisms that account for the stage of business growth appear sensible

and should be taken into account despite current trends towards continental or global harmonisation of governance procedures and practices. The cultivation of an evolutionary view of corporate governance implementation attains a degree of importance, seen in this perspective. Equally important is the realisation that both process and content of governance mechanisms play a critical role in the success of the small entrepreneurial firm. This is particularly critical in distinguishing between corporate and family governance mechanisms, both of which are required for the family-controlled firm. Within this context, avoiding a universal 'best way' for small family-owned concerns under different legal systems would appear to provide a sensible approach in terms of what not to do. Greater emphasis on understanding the business complexities faced by small firms along the various stages of the life cycle is a step in this direction.

Accordingly, greater emphasis on management, organisational design and motivation grounded in flexibility offers a way to enable smaller firms to maximise the potential for improved governance. This requires both creativity and flexibility of approach towards governance formulation. One way to achieve such creativity could be through the practical application of the principle of subsidiarity to the governance systems in small businesses, coupled with fiscal incentives provided by the State. Incorporating sustainable employee participation schemes in the governance process – one that is geared towards the realities of the small family-owned business – could potentially provide an avenue for improved survivability and performance for these entrepreneurial enterprises.

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