Discrimination of Corporate Governance Principles by Agents in Turkish SMEs

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Abstract

The main purpose of this study is to investigate whether managers and owners of SMEs have different levels of interest towards corporate governance principles. Specifically, we aim to reveal which corporate principles discriminate owners from managers in SMEs. In order to investigate this, we collected data from owners and managers of 147 firms. Our analyses results revealed that one variable in discriminating between owners and managers was the most significant, which was namely accountability.

Keywords: Corporate governance, SMEs, agency theory, discriminant analysis

Introduction

Family-owned Small and Medium Sized Enterprises (SMEs) contribute to national economies in a great amount (Miller et al., 2003). Even though it is ignored, these enterprises also account for a large percentage of economic activities in the World and in Turkey. The percentage of SMEs to other enterprises in an economy is expected to be around 90% and their contribution to employment rates of countries is significantly high (Schanker and Astrachan, 1996; Chua et al., 2003; Miller et al., 2003; Erdogan et al., 2006). Because of certain advantages, they provide, such as flexibility to adapt environmental changes, easy application of communication and knowledge sharing practices and effective customer relationships, SMEs have been evaluated as favorable economic institutions. Providing these advantages, SMEs attracted a significant number of researchers to design studies on different aspects of SME practices. While some of these studies focused on problems of SMEs (Akdeniz, 2005; Erdoğan et al., 2006), others used family businesses and corporate governance frameworks (Dyer, 2003; Miller et al., 2003) in designing their research. As Dyer (2003) points out that because SMEs are mostly family-owned firms and experience certain managerial problems, it makes them vulnerable to go out of business even without passing to second or third generation. This fact necessitates SMEs to apply corporate governance principles, which requires to establish a managerial structure that is independent from founders and family members' direct influence on decision making practices and work processes. In this sense, it is crucial to note that the success to apply corporate governance principles in SMEs will depend on the level of appraisement of these principles by owners and managers in a favorable way. In this study, we aim to explore which corporate governance principles would be used to discriminate most between owners and managers of SMEs based on their appraisement of these principles. Providing a national empirical grounding, this study also tries to fill a gap in corporate governance literature, which is the scarcity of cross-national studies (Kim et al., 2005; Durisin and Puzone, 2009).

To state this paper on a more stable ground, in theoretical framework section, we will theoretically examine the links that tie corporate governance principles and agency theory considerations. We also mention about tenets of altruism perspective to strengthen our hypothesis that family members would emphasize differently to corporate governance principles than agents in SMEs.

Theoretical Framework

Increasingly complex and turbulent business world necessitates adapting good governance mechanisms to deal with coordination and control problems in organizations. Therefore, as a mainstream management approach, corporate governance has received a great attention and contributions from many disciplines such as, management, accounting, economics, finance, and law have been made. To resolve coordination and control problems certain monitoring mechanisms are utilized including "the composition of the board of directors, the leadership structure of the firm, the ownership structure of the board, CEO compensation, CEO ownership, and CEO tenure" (Coles et al., 2001: 29). These governance mechanisms are used to oversee the activities of managers, namely agents, as agency theory indicates. In this context, the tenets of agency theory is crucial to examine to understand the true nature of the governance mechanisms, especially roles and expectations of principles and agents in coordination, decision making, and control issues.

It can be indicated that most of the corporate governance studies have been based, mainly, on agency theory. As the agency theory concerned with principle-agent relationships (Jensen and Meckling, 1976; Greenwood, 2003; Schulze et al., 2003a,b), it is postulated that, in such a relationship, one party (the principal) hires another party (agent) to perform certain managerial task by delegating authority for decision-making. As a result of delegating decision-making authority, the agent might exhibit self-serving behavior. As assets are property of owners/shareholders, a principal-agent problem may arise because of possibility that the agent will be inclined to favor his or her self interests over those of the principal (Young, et al., 2000; Voordeckers et al., 2007). The theory is concerned with mechanisms that managers act in a way that best meets interests of owners (Coles et al., 2001). Furthermore, agency theory is interested with aligning interests of managers and owners.

Taking family firms into consideration, altruism theory posits that principal and agent relationship is influenced by family ties. Altruism fosters loyalty and commitment to the family and to its prosperity (Ward, 1987; Schulze et al., 2003a,b). Even though Schulze et al. (2003a:475) point out the possibility that altruism can create agency problems within the household, such as children's intention to squander their parent's money, to be dependent upon their parents, and to leave an assigned household chore for a parent to complete, authors highlight the agency benefits of altruism. These benefits include family agents' tendency to align their interests with those of other family members, which reduces the need to monitor family agent performance and a high level of interdependence among family agents (Schulze et al, 2003a,b).

Even though, altruism provides certain benefits for family firms, agency problems of altruism should also be pronounced. First, CEOs grant certain privileges to family agents in terms of hiring family members based on their family status. In turn, a variety of agency costs come out and CEOs need to closely monitor the work of family agent to make sure that the decisions and activities are appropriate with the family agent's position and level of authority. Second, CEOs get used to certain biases about employed children over time and it reduces their ability to effectively monitor family agents. Even though, CEOs and family members' interests, occasionally, collide with one another; generally they have different perceptions and approaches about how to make decisions and distribute authority during governing processes. Other problems in family firms stem from the possibility that family members are not qualified for positions, lack of discipline, conflict between priorities of family members, and conflict between family and non-family members.

In order to formalize corporate governance, we used four well-known governance principles namely, responsibility, transparency, accountability, and fairness. Responsibility implies that while creating value for shareholders, the company should behave responsible in its activities by applying law and regulations that reflect societal values. Transparency principle states that corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the firm. Accountability refers to corporate governance framework's responsibility to ensure the strategic guidance of the firm, the effective monitoring of management by the board, and the board's accountability to the firm and shareholders. The last principle, equitable treatment of shareholders posits that the corporate governance framework should ensure the equitable treatment of all shareholders. The principle stresses on the notion that all shareholders should have the opportunity to obtain effective redress for violation of their rights. By taking agency and corporate governance approaches, which are discussed above, into account we can hypothesized that firm managers and owners have different levels of interest towards corporate governance principles.

Recent company crises in business world necessitates SMEs to apply good management practices to be able to protect their capital structure, market share and strategic priorities. In this sense, SMEs need to adapt a new structure, which is independent from any direct influence of family members. Corporate governance is the term, which classify this new way of management and provide advantages for SMEs. By the same token, current transformation and periodic crises in Turkish economy necessitates Turkish SMEs to adapt corporate governance principles to be able to adapt to fast changing environment in which many firms try to change themselves according to these new standards.

It is unfortunate that the research on SMEs in the World and in Turkey is not satisfactory. As a country specific research, this study aims to compare appraisement level of these principles by owners/managers in Turkish SMEs. Specifically, we aim to learn whether there is a difference between owners/managers' appraisement of corporate governance principles. If any difference has been figured out, the next step should be to examine potential causes for this difference.

Methodology and Findings

In tis part of our study, the reader may find methodology we used in collecting data and discussions about results of analysis, which is conducted to test our hypothesis.

Methodology

In order to test our hypothesis, we developed a structured questionnaire, which consisted two parts: The first part consisted demographic questions about participating firms and the second part 28 questions measuring corporate governance principles, which are aimed to be appraised by firm owners and managers. We administered the questionnaire by reaching to owners/managers of 147 firms in Eskişehir region, which is a medium-level developed city in central Turkey. 62 of the firms registered to Chamber of Commerce and 85 of them to Chamber of Industry. We communicated with every owners/managers face to face to make sure that they clearly understood every question asked. After collecting data, we performed a number of reliability analyses and reached following results: Cronbach's Alpha for whole scale was (.92). Cronbach's Alpha values for each corporate governance principles were: Fairness (.81), responsibility (.77), transparency (.82), and accountability (.85).

Findings

In order to determine which corporate governance principle is most efficient in differentiating owners from managers, a two-group discriminant analysis is performed. Because our aim is to determine which variables are the most efficient in discriminating between owners and managers and not simply to determine the discriminating capabilities of the entire set of variables, a stepwise procedure will be employed.

Two-group stepwise discriminant analysis results revealed that one variable in discriminating between owners and managers was the most significant, which was, namely, accountability (see Table 1 and Table 2). As it can be observed from tables, this variable meets the conditions of F value (11.694) greater than minimum acceptable level of 1.0 and significant Mahalonobis Distance (D^2= .244, p= .001), and Wilk's Lambda value (.944) entered in the model by stepwise discriminant analysis. Accountability variable entered in the model as having the most discriminating power among four corporate governance variables.

Table 1. Test of Equality of Group Means for the Discriminant Analysis Between Owners and Managers Having Different Appraisements for Corporate Governance Principles

Variables	Wilk's Lambda	F	p	Group 1 Mean	Group 2 Mean
Accountability	.944	11.694	.001	2.89	3.23

Group 1: Owners Group 2: Managers

Table 2. Summary of Stepwise Discriminant Anaylsis Results

Steps	Variables Entered	Wilk's Lambda		D^2	
		Value	p	Value	p
1	Accountability	.944	.001	.244	.001

The multivariate aspects of the model can be observed from Summary of Canonical Discriminant Functions table (Table 3). It can be seen that the discriminant function is highly significant (.001) with a canonical correlation value of (.237). By squaring canonical correlation value $(.237)^2 \sim .06$, we can conclude that 6 percent of the variance in the dependent variable (ownership and management) can be explained by this model, which includes one independent variable.

Table 3. Summary of Canonical Discriminant Functions

Function	Eigenvalue	Canonical Correlation	Wilk's Lambda	Chi-square	df	p
1	.060	.237	.944	11.329	1	.001

Centroids: Group1: -.292 Group2: .202
Percent of cases correctly classified: 70%

Table 4. Loadings for the Discriminant Analysis Between Owners and Managers Having Different Appraisements for Corporate Governance Principles

Variables	**Function 1**
Accountability	**1.000**
Equitable treatment	.598
Transparency	.578
Responsibility	.500

In order to assess the predictive ability of the discriminant function, the classification accuracy of 70 percent is compared with the proportional chance criterion, which is calculated by using following formula:

$C_{PRO} = p^2 + (1-p)^2$

where

C_{PRO} = The proportional chance criterion

p = proportions of owners/managers in group 1

$1 - p$ = proportions of owners/managers in group 2

By substituting appropriate values in the formula, we calculate:

$$C_{PRO} = (.41)2 + (.59)2$$
$$= .168 + .348$$
$$= .516$$

As it is indicated by Hair et al. (1995), the classification accuracy should be at least one-fourth greater than that achieved by chance, our example meets this criteria: 70% > 64.1%, which is calculated by (51.6% + ¼ * 50 = 64.1%), providing us an acceptable level of predictive accuracy.

In interpretation of the discriminant function, the discriminat loadings (see Table 4) will be used because of the consideration that the loadings are more valid than the weights. In stepwise procedure, identifying significant discriminators are easier because nonsignificant variables are prevented to enter the function. As it can be observed from Table 4, the variable with highest loading is accountability. When we refer to Table 2 back, we can observe that mean score of accountability is higher for managers, implying that managers are more inclined to favor accountability as part of application of corporate governance principles in their firms than owners do. Overall, results suggest us that our hypothesis finds partial support from the analysis conducted.

Conclusion

The purpose of the present study was to explore which corporate governance variables are more efficient to discriminate between owners and managers of SMEs based on their appraisement of these principles. Our results indicate that compared to owners, firm managers have more positive attitudes towards four corporate governance principles and try to apply them in their managerial applications. Analysis results revealed that the most discriminating corporate governance principle is accountability. Because the main responsibility of managers is to ensure a successful and sustainable management by protecting and using firm resources effectively and responsibly; they are monitored by board members and shareholders. Because of the importance of strategic movements, they are highly visible and must behave in a way that satisfies board members and shareholders. The level of difference between owners and managers may reflect firm managers' concern to be successful in the eyes of concerning parties and satisfy them by sharing available data. Another reason for this difference can be explained by the level of responsibility that is given by family firm owners to managers with an agency agreement. As a result, owners might feel responsible less responsible for firm performance and evaluate it as main responsibility of the managers. Evaluating the result on the part of managers, it can be commented that career advancement of managers depend on their capability to persuade board members and, in a way indirectly, shareholders. Personal expectations of managers to be strategically successful and to get monitored by concerned parties should be regarded as another reason for analysis results.

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