SME GOVERNANCE GUIDEBOOK

Canada

IFC | International Finance Corporation
WORLD BANK GROUP

Creating Markets, Creating Opportunities

SME
Governance
Guidebook

Contents

Boxes, Figures, Tables, and Worksheets

Worksheets

Unless otherwise indicated, all boxes, figures, tables, and worksheets were produced by the authors.

Foreword

Private companies seek to maximize profits, enhance growth, and ensure long-term sustainability. Regardless of a business's size, there is overwhelming evidence that effective corporate governance is an essential element for achieving these outcomes.

Yet when asked about corporate governance, owners of small and medium enterprises (SMEs) often are skeptical of its value add. They either believe that the business is too small or that it is too early in its development to benefit from building out corporate governance systems and processes.

For those interested small business owners, most corporate governance principles and standards are not fit for their business. Implementing policies and procedures designed for larger companies can represent an overly complex and resource-intensive effort for the typical resource-strapped SME.

This Guidebook specifically addresses the challenges and opportunities faced by SMEs at the various stages of their lifecycles, offering tailored corporate governance recommendations for these smaller businesses. The guidance provided is designed to help SME owners, investors, and managers take a pragmatic approach to governance, as a means of strengthening their businesses over the long term. The Guidebook is designed to enable SMEs to move at their own pace on governance upgrades, depending on market context, growth stage, resources, and degree of organizational development.

The Guidebook builds on more than two decades of IFC leadership in corporate governance. Our even longer record of supporting SMEs in emerging markets includes a range of initiatives, from advice on improving business practices to enabling increased access to finance in partnership with banks, private equity, and other financial intermediaries: in 2017 alone, IFC clients provided more than $351 billion in SME loans.

As the primary source of private sector growth and job creation in many emerging-market countries – and the innovation pool from which tomorrow's big businesses will emerge – well-run SMEs represent a powerful driver of economic expansion and job creation.

We hope this Guidebook will help you develop governance policies, practices, and structures that will enable your company or your investees to grow sustainably, generate wealth for shareholders, and benefit your employees and communities.

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Acknowledgments

Executive Summary

Small and medium enterprises share distinctive challenges that require specific governance practices. However, resources on corporate governance have mostly focused on large and publicly traded companies. This Guidebook is written with SMEs specifically in mind and provides insights into the particular risks that these businesses traditionally face. It proposes a tailored governance framework with structures, policies, and practices that mitigate these risks and support sustainable growth of business while recognizing the resource constraints typical of SMEs.

For many SMEs, the initial incentive to improve their governance practices is an increase in access to cheaper financing options. Investors analyze governance practices of companies to evaluate their risk exposure and to determine a proper value to the shares of the company. However, benefits of good governance go beyond increased access to finance. Research and empirical evidence show that good governance improves business performance and increases the chances of a company's long-term survival (IFC 2018).

In practice, the most common SME governance challenges involve decision making, strategic oversight, recruitment and retention of qualified management staff, succession, and establishing standardized internal control mechanisms and policies. These challenges stem from the very nature of SMEs, many of them family businesses, which typically experience organic growth, and more often than not, the systems, policies, and processes required for the proper governance of the business lag behind. This organic growth—combined with ambiguity in business roles (with key personnel wearing multiple hats), an informal approach to business, family involvement at various levels, and an often insular leadership focus—is unsustainable in the long term.

The objective of this Guidebook is to help SME entrepreneurs and their investors develop a highly tailored governance improvement plan to support

sustainable growth of their companies. The SME Governance Methodology in this Guidebook represents a governance innovation by tailoring specific recommendations to the evolutionary stages of SME growth: *Stage 1: Start-Up*; *Stage 2: Active Growth*; *Stage 3: Organizational Development*; and *Stage 4: Business Expansion*. The recommendations are grouped around five governance topics: *Culture and Commitment to Good Governance*, *Decision Making and Strategic Oversight*, *Risk Governance and Internal Controls*, *Disclosure and Transparency*, and *Ownership*.

Research and empirical evidence show that good governance improves business performance and increases the chances of a company's long-term survival.

Easy-to-use tools help SMEs learn more about key governance concepts, understand recommended governance practices specific to their stage of growth, and apply practical solutions. Throughout the Guidebook, worksheets and action-planning templates help translate intentions into actions.

This Guidebook provides an international perspective—focusing on characteristics that are common to small and midsize businesses in many different countries. When *applying* the Guidebook's recommendations, companies also need to be considerate of the practices and regulations of the countries where they operate.

We hope that implementing these leading practices will go a long way toward ensuring SMEs' sustainability—and their attractiveness to future investors, employees, and other stakeholders.

Guidebook Structure

Chapter 1—SME Governance: What Is It? Why Is It Important? This chapter explains what corporate governance is and how it differs for SMEs. It also discusses the benefits that SMEs can derive from good governance, including access to finance.

Chapter 2—SME Governance Framework defines the stages of growth for SMEs as well as governance-related risks and opportunities associated with each stage. It provides a tool to help companies determine their stage of growth, then it introduces the SME Governance Matrix, which aligns the SME growth stages with recommended actions on five governance topics.

Chapter 3—Key Governance Topics and Leading Practices takes a deep dive into select governance concepts and practices for each of the five governance topics. Discussion of each topic ends with specific recommendations for each stage of SME development.

Appendix—SME Governance Action Planning Tool distills the key recommendations of the SME Guidebook and presents them in the form of worksheets to help you identify high-priority actions appropriate to your SME's stage of growth.

Chapter 1

SME Governance:
What Is It? Why Is It Important?

"If management is about running business,
  governance is about seeing that it is run properly.
  All companies need governing as well as managing."

Tricker 1984[1]

1. SME Governance:
What Is It? Why Is It Important?

At the end of this chapter, you should have a better understanding of the following:

▶ **The importance of SME governance, and**

▶ **How SME governance helps you secure and grow your business.**

THIS CHAPTER sets up a case study – the experience of Rockstar Clothing Company, a fictionalized story based on a real company – to illustrate the material we'll cover. Then we will review what corporate governance is and explore why SMEs have specific needs. Finally, we will look at some of the benefits that SMEs derive from good governance, including access to finance.

[1] Bob Tricker is an expert in corporate governance who wrote the first book to use the title 'Corporate Governance' in 1984.

rockstar

Case Study: Meet Rami Bahgat[2]

Today's the big day! Rami Bahgat, the chief executive officer of Rockstar Clothing Company, dreams of expanding his clothing business from its current 12 stores to 100, and he's about to meet with Sandstone Equity Group to discuss what he sees as a win-win for all parties involved. For 29 years the company has provided high-quality men's clothing to the Egyptian market with much success. Rockstar has proven itself with great products already tested on the market, but only with a significant investment can the potential for growth be realized. To attract investment, Rami put together his proposal, intending to offer up to 30 percent of equity in his company to investors. He thought he had done everything necessary to be ready to discuss the product, company strategy, and finances.

However, Rami was not prepared for some of these questions: How are key decisions made? Who are the people with essential knowledge and expertise, and how do you plan succession for these key risk positions? How do you manage risks? How can I see what's happening with the company? How can potential investors be sure the information provided is correct and complete? What relationship do you offer to your shareholders?

These are some of the questions the potential investors raised, and they all speak to the issue of *governance* within Rockstar Clothing Company. These investors wanted to understand how committed the company was to good governance, how decisions were made, and whether there were structures in place for oversight. They were also interested in knowing what kind of controls were in place to protect the company from risks and whether Rami would be committed to practicing transparency and sharing information with outsiders. Finally, they wanted to understand how they, as *external* investors, would fit in with this close-knit family company.

In his search for answers, Rami discovered that he did have some of the governance structures, processes, and systems in place. Like most businesses, he was already practicing governance without even knowing it! However, his meeting with investors made him realize that he needed to address governance in a more structured and effective way.

With that in mind, Rami is setting out on a journey to assess and improve governance in his company. He is confident that this process will lead the company to perform better, grow, and become more sustainable—and make it more attractive to investors. This case study will help us illustrate key governance challenges for SMEs—and potential solutions.

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2   All the names and some details have been changed to protect the identity of the company.

Figure 1.1: The Principal Actors: Shareholders, Board of Directors, and Management

SHAREHOLDERS
Shareholders set the overall
vision for the company

Manage capital for shareholders

Provide capital

Represent and report to

Elect and dismiss

Report periodically and implement strategy

Guide and supervise

MANAGEMENT
Management develops
the strategy and runs the
company's daily operations

BOARD OF DIRECTORS
The Board of Directors reviews and
approves the strategy and
oversees management

What Is Corporate Governance?

"Classic" corporate governance—developed initially for large publicly traded companies—is defined as the structures and processes by which companies are directed and controlled. It focuses on the interaction among three key decision-making bodies: **shareholders**, **board of directors**, and **management**. **(See Figure 1.1.)**

Shareholders own assets, provide capital to the business, and appoint the board to oversee it. The board sets strategic direction, supervises the performance of management, and reports to shareholders on its stewardship. Management uses the assets and capital provided by the shareholders to realize a positive return for them, and reports on its performance to the board. Increasingly, good governance also includes active engagement of other stakeholders.

Over time, corporate governance codes and guidelines have expanded beyond listed companies and now cover a broader range of organizations, including family businesses, state-owned enterprises, and even charitable organizations.[3] According to the European Confederation of Directors Associations (ecoDa), good corporate governance for unlisted companies "is about establishing a framework of company processes and attitudes that add value to the business, help build its reputation and ensure its long-term continuity and success" (ecoDa 2010).

What Makes SME Governance Different?

Definitions of SMEs vary, but typically they are described as registered companies with fewer than 250 employees (OECD 2005). In some instances, definitions also include revenue thresholds, but these vary widely by country and industry. For consistency throughout this Guidebook, we use the definition based on the number of employees, which places the vast majority of companies in the SME classification.

To survive and grow, all businesses need to be **properly governed**. SMEs, many of which are family businesses, differ from larger organizations in more ways than just size. To be effective for SMEs, a governance framework must include the additional complexities that are part of their nature.[4]

For example, corporate governance in large organizations is often associated with the "principal-agent" issue, in which the interests and incentives of the agents (managers) may not be perfectly aligned with those of the principals (shareholders). However, in the in the early stages of SMEs, the issue is less likely to arise, and when they evolve further, the principal-agent problem takes on a different form. The majority shareholder typically remains involved in operations as managing director, and there is a danger that *minority* shareholders' interests are not fully respected.

Another way SMEs differ from their larger counterparts is their highly dynamic nature. Challenges faced by SMEs change dramatically as they grow in size and as they experience changes in their organizational, management, and ownership structures.

Also, many SMEs operate with less-formal structures, policies, and processes. Without some formal guiding framework—and with key personnel often wearing multiple hats (manager, board director, and shareholder)—a growing SME faces significant challenges in the decision-making process in several critical areas, such as financial management and succession planning. Add to this the implications of family involvement (including intergenerational) at the various levels in the business, and it becomes clear that traditional governance frameworks need to be adjusted to meet the distinct needs of SMEs.

Most governance guidance for SMEs has traditionally amounted to "simplified" versions of practices recommended for larger companies, but recently there have been several important efforts to change this. For example, Corporate Governance Guidance and Principles

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3   For examples, see IFC Governance Tools at ***https://bit.ly/2s6wkGq***.

4   For helpful insights on this topic, see ACCA 2018.

for Unlisted Companies in Europe (ecoDa 2010) uses a phased approach, making a distinction between the use of a basic framework that applies to all companies, including the smaller ones, and then more sophisticated measures for larger and complex organizations. Some codes and guidelines analyze how the core governance principles can be interpreted for SMEs (for example, see IoDSA 2010). Finally, some guidelines go further and aim to account for the heterogeneity of SMEs by varying recommendations depending on key company characteristics, most commonly size, organizational complexity, and shareholding structure. For a great example of this approach, see HKIoD 2009.

IFC has built on this foundation by adding another element—firm growth. As a development institution, IFC strives to help SMEs not only survive but also grow and prosper. IFC developed the **SME Governance Matrix**, presented in Chapter 2, which serves as the basis for this Guide. It is a growth-oriented governance model, which tailors governance recommendations to evolutionary stages of SME growth. The governance tools in this Guidebook do not push entrepreneurs toward common "best practices." Instead, entrepreneurs learn how to identify the stage of development of their business and to find practical governance solutions that are coherent and practical for their stage—to promote the further sustainable growth and long-term success of the business.

Why Bother? The Benefits of Good Governance for SMEs

SME business owners often delay improving governance until some point in the future—when they're "big enough." As a result, these businesses miss out on key tools and solutions that could improve their competitive survival and growth. Also, delaying implementation of governance until the business is large and fully formed can mean that, when that implementation does come, the business may find the process to be a radical and disruptive shock.

A better approach is for entrepreneurs to start—early on—governing their business based on the fundamental principles of good governance, using the solutions and tools appropriate for their company's stage of development. **Good governance is a long journey, and the sooner SMEs start adopting good practices, the more benefits they can reap along the way.**

Good governance is not a panacea for all of the problems SMEs face, but studies have shown that it is an undeniably important ingredient for their success (OECD 2010).[5] Conversely, research findings consistently show poor governance practices to be directly linked to poor business performance, fraud, and catastrophic failures.

Implementing good governance practices helps SMEs address a number of the distinctive challenges (ACCA 2015; ecoDa 2010). For example:

▶ Effective policies, structures, and processes help reduce overreliance on a few "key persons."

▶ Companies with sound governance have better access to finance, as they appear more attractive and less risky for investors and banks.

▶ Family-run businesses increase the chances of long-term survival through proactive succession planning and managing the family-versus-business relationship.

▶ Prudent governance reduces risks and improves the managing of conflicts among various shareholders and stakeholders

▶ Well-structured management bodies (and later, boards of directors) provide critical stewardship, strategic direction, and business connections for sustainable growth.

▶ Good governance is a common regulatory prerequisite for an IPO (initial public offering).

5   For instance, see Brunninge et al. 2007 and Abor and Biekpe 2007.

▶ Prudent internal controls help companies enhance risk management and build greater resistance to fraud, theft, and mismanagement.

▶ Good governance practices help the founders recover some freedom in their lives. They can control and direct the business without having to be directly involved in all operational decisions. Well-governed companies attract and retain higher-quality staff that the founders can rely on.

Good Governance Is a Good Investment

Access to finance is a key constraint to SME growth. SMEs are less likely than large companies to secure bank loans and instead rely on internal or "personal" funds to launch and initially run their enterprises. According to one study, "about half of formal SMEs don't have access to formal credit" (World Bank 2018).

One key way an SME can increase its access to finance is by strengthening its governance practices. Further, SMEs interested in attracting investors can use better governance as a core value proposition. Various providers of risk capital for SMEs, such as private equity and venture funds, understand that good governance means greater security as well as better return on investment.

Today, an increasing number of investors include good governance criteria as part of their investment determination process. In a 2010 IFC survey of institutional investors in emerging markets, 41 percent stated that their companies had a certain minimum

governance threshold for investment decisions (Khanna 2010). Moreover, good governance allows entrepreneurs to receive substantially more money for shares in their companies. In the same survey, 100 percent of respondents indicated that they would pay a higher investment premium for well-governed firms in emerging markets; 55 percent said they would pay at least 10 percent more, and 38 percent were willing to pay 20 percent more for well-governed companies.

These findings support a 2015 report indicating that MENA[6] institutional investors identified good investee governance as one of the top three challenges for the industry (IFC 2015b). They also noted the effects of good governance on their investee clients. For example, one investor cited a recent strategic sale exit that attracted a 40 percent premium over market price, due largely to good governance. A technology investee company of another investor increased its profitability by 20 percent over a two-year period as a result of improvements at the board level and several changes in management control.

In summary, improving governance practices upgrades a firm's performance, enhances risk management, builds trust among stakeholders, and increases the ability to access outside capital. That's why investors are willing to pay a premium for well-governed firms—and to dedicate energy to improving the governance of companies they have already invested in.

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6 MENA = Middle East and North Africa region.

NEXT: Chapter 2 takes a close look at the evolution of SMEs and introduces the overall framework for building sustainable, well-governed businesses.

Chapter 2

SME Governance Framework

2. SME Governance Framework

At the end of this chapter, you will be better able to do the following:

▶ **Understand some of the typical driving forces behind SMEs' progression from one stage to another.**

▶ **Identify the stage of development for your own business.**

▶ **Understand the overall framework of recommended governance to support your company's development.**

THIS CHAPTER defines the stages of growth for SMEs, plus governance-related risks and opportunities associated with each stage. It provides a tool to help you determine the stage of growth for your own business. Then it introduces the SME Governance Matrix, which summarizes key governance actions recommended for each stage of SME development.

SME Stages of Growth:
How Is My Business Evolving?

At the end of this section, you will be better able to do the following:

▶ Differentiate between the different evolutionary stages of SMEs.

▶ Identify your business's primary stage of development.

▶ Appreciate the needs and risks associated with each SME stage.

▶ Discover the role of governance in mitigating stage-specific risks.

There is a lot of literature on the topic of company growth and evolution, largely under the broad umbrella of organizational lifecycle models.[7] Although there is no academic agreement on the number, the sequence, and the movement of stages, there is broad consensus that the conditions vary along similar patterns as the SMEs grow, and that there are common challenges at various stages of their development.

This means that over the life of their business, SME owners will experience definitive moments when critical decisions have to be made to move the business to the next level. Owners should view governance as an evolutionary process, where the systems and processes need to remain **fit for purpose** as they progress along with the business.

Based on our analysis of the literature, as well as IFC's own SME advisory experience, we suggest that you think of successful SMEs as evolving through four distinct stages of growth. (**See Figure 2.1.**) Stage transitions—from Start-Up to Business Expansion—are defined not only by traditional factors, such as ownership structure, size, and the enterprise focus, but more importantly by the increasing internal complexity that comes with growth. No single factor defines the exact point of stage transition, but rather *the combination of stage characteristics will indicate the SME's primary evolutionary stage*. It's also important to note that the stages are dynamic—a company might be "between stages," in the process of moving from one stage to another.

7   For short and practical literature reviews on the topic, we recommend Matejun and Mikoláš 2017 and Nordstrom et al. 2012.

Figure 2.1: The Four Stages of SME Evolution

Stage 1

START-UP BUSINESS

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Stage 2

ACTIVE GROWTH

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Stage 3

ORGANIZATIONAL DEVELOPMENT

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Stage 4

BUSINESS EXPANSION

SME Governance Framework

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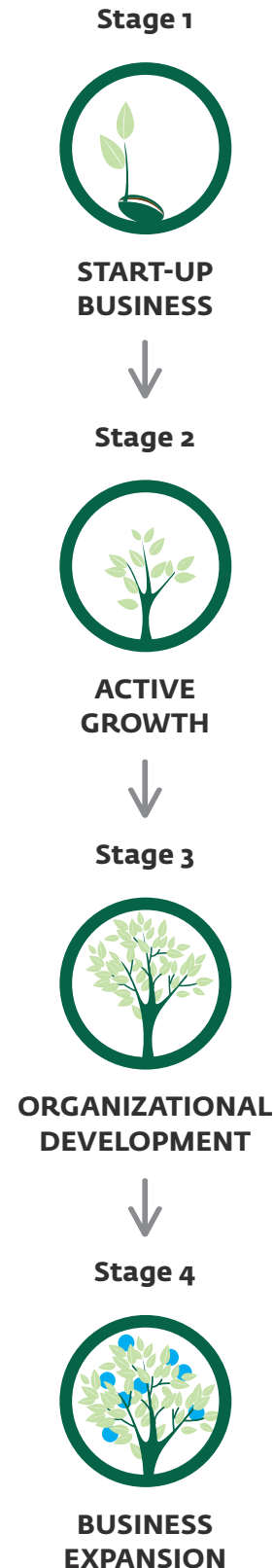
Transition points between SME stages are often identifiable by the way they push the owner into making decisions that are beyond "business as usual." In Stages 1–3, the catalyst for these changes is most often the increasing business complexity precipitated by exponential growth. In the later stages (Stages 3–4), the transition is usually stimulated by a significant change in ownership (for example, a new shareholder, investor).

In the following pages, we will take a closer look at each evolutionary stage, using the Rockstar Clothing Company as an illustration. The SME *stage scenarios* will present risks commonly associated with each stage—from the perspective of the enterprise and of potential external investors that might be needed to fuel further growth. We then demonstrate that by adopting stage-appropriate governance practices, owners can mitigate (take actions to minimize or eliminate) these risks and help the company move to the next stage.

Note that this stage-progression narrative presents an optimistic scenario. In practice, stagnation and even decline can happen at any stage and for a variety of reasons, including failure to address governance risks.

Stage 1: Start-Up

rockstar

Case Study: Rockstar Origins

It's 1985, and Rami Bahgat is starting a clothing venture, Rockstar Clothing Company. It will specialize in men's casual and formal wear. Its business model is to create the designs in-house, outsource the production and dying of cloth, and distribute the end product. Rockstar's ownership is confined to Founder/Chief Executive Officer (CEO) Rami Bahgat and his wife (controlling share) and a couple of minority shareholders.

Rami is developing his product line and testing various designs on the market. The team is small, with his wife providing the main support. Everyone pitches in as needed to keep things moving. There is a board of directors, as was required by law, but it is purely a formality.

In fact, Rami personally controls every aspect of the business and is designing the business systems as he goes along, making all decisions, and doing whatever it takes to meet customer demands.

In **Stage 1: Start-Up**, SMEs are focused on **product development** and testing the markets. With this single-minded focus and limited resources, SMEs typically put little effort into organizational development. At this stage, operations are pretty straightforward and simple, encouraging an informal and agile approach to managing them.

The management style is individualistic—the owner and the business are effectively one and the same. The business is growing organically, with systems designed "on the go," and distinct roles are defined as individuals lend a hand, as needed, to get the job done.

At this stage, the owners/managers are required to be primarily entrepreneurs—having the overall vision and making new things happen. They thrive in the unrestricted nature of Stage 1 operations—with its flexibility, open communication, and generally informal business approach.

Risks for the enterprise

The informal nature of an SME at this stage may lend itself to a rush to implement rules, systems, and procedures that can inadvertently slow the company's product development and agility. Premature moves to do too much delegating may lead to the founder's loss of control. On the other extreme, a complete refusal or inability to start delegating may lead a founder to become dictatorial and to fail to make good use of the company's managerial and technical talent. There is also the risk that the founder will not communicate effectively, leading to information gaps in the team. Also, Stage 1 SMEs often have long-term investment goals but short-term financing capabilities, which can spread cash and resources too thin and increase uncertainty.

Risks for external investors

Investors are concerned that start-ups don't intend to develop accountability structures and don't have in place even the most basic systems and policies. Related to this is the risk that the founders are making all of the decisions and aren't seeking advice on business strategy from a third party, or even internally. Overreliance on the founder creates a big key-persons risk. Another factor is a mixing of family and business interests. This brings an increased emotional component which tends to result in a lack of clarity or transparency in decision making, especially in financial matters. Also, communication about business performance can be biased and unreliable; founders may not be ready to include other shareholders in the business.

Focus of mitigating actions

An SME can begin to address these risks by adopting informal mechanisms for incorporating external advice, implementing cost-effective systems for cash flow management, identifying core functions needed for further growth, and starting a gradual shift toward more inclusive management and longer-term strategic thinking.

Stage Transition: Stage 1 to Stage 2

Once the SME develops and tests a successful product or service offering, selling becomes the number-one priority. Despite the transition from Start-Up to Active Growth being highly desired by an SME owner/founder, it is often essentially unplanned. In fact, the business may begin ballooning with increased staff numbers but little or no change to the business structures and processes.

rockstar

Case Study: Rockstar Today

As of writing of this Guidebook, it has been 32 years since the establishment of Rockstar Clothing Company, which now has 12 stores across Egypt and 60 employees working in a number of functional departments: stores, finance, accounting, warehousing, and administration. The company reported a sales turnover of 10 million Egyptian pounds ($1.5 million). Rami's vision is for Rockstar to have 100 outlets across Egypt in 10 years.

The company has a basic organizational chart but with no job descriptions or reporting lines in place. Rami has admitted to running a "one-man show" but feels he has little choice, given the reported "lack of good staff." Aside from his son, Sherif (the merchandising executive), he consults only with the sales manager, Mahmoud. Interviews to hire a professional human resources (HR) manager have been unsuccessful thus far. Also, his son sees his own role in the business as temporary, and he has shared his view that his father is a better designer than manager.

Monthly senior manager meetings (when they occur) are informal and focus on operational issues only. But with an eye on sales, Rami meets frequently with Mahmoud, who says incentives are offered to staff to stimulate sales, but the company has never communicated how these are calculated.

The company set up a basic system of checks and balances for monitoring inventory, but a physical inventory is performed only once a year, at best. No major internal discrepancies have been identified, but there is concern over cash flow shortages and payment defaults, because of high inventory.

When asked about the vision of the company's future, neither the senior managers nor the staff were aware that Rockstar even had a vision—or a strategy to implement it. With no concrete business plan and poor cash flow, it will be a real challenge to finance an expansion and hire sorely needed professional staff.

By **Stage 2: Active Growth**, the basic product offering has been developed, and SMEs are focusing on sales, sales, and sales! The company is rapidly growing in size and complexity. However, this growth often remains largely "organic" and unplanned—it is based on a broad "vision" but with little attention to the development of a defined strategy .

Risks for the enterprise

Companies struggle to balance the need for flexibility with the growing demand for strategic focus, defined structures and policies, and effective controls.

HR issues become increasingly apparent. Companies often build structures, functions, and processes around *available* people as opposed to hiring specifically *qualified* people to perform predefined functions. With the rush to meet rising demand, SMEs often hire too many employees and draft people into roles outside of their current qualifications. Reporting lines, authorities, and responsibilities remain vaguely defined.

At this stage, the business already has a track record of success, and that can lead the CEO to become overconfident and to lack focus in decision making. There is a lot going on! With the formation of functional divisions, growing staff, changes in products and services, and new opportunities for growth, the founders can find themselves pulled in various directions as they struggle to hold onto control and focus on strategic development.

A common complaint in this stage is the limited or "silo" approach to communication, where there's good communication *within* departments and functions but limited communication *between* them. Internal controls begin to emerge to deal with increased delegation and company size and complexity, but they remain rudimentary.

Risks for external investors

Unclear systems and policies are a major risk factor; and with the excessive concentration of power in the founder/CEO, the key-person risk remains high and internal company checks and balances can be ineffective. The risk of unequal treatment of some shareholders is also a major concern.

Focus of mitigating actions

Governance practices recommended for this SME stage focus on developing basic organizational structure and processes. The company also needs to start defining its approach to operational and strategic decision making. The founder/CEO has to learn to delegate and to consult with key personnel and external advisers—even if on an informal basis—before making important decisions. Internal controls need to be introduced to promote accountability and to secure assets.
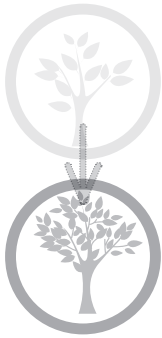
After focusing on the product in Stage 1 and sales in Stage 2, the owner, driven by the challenges of increasing business size and complexity, realizes it is time to invest in developing the company itself: Stage 3.

The owner notices that sales growth may have slowed down while the company has grown dramatically, with new divisions, products, and people. The internal structure, policies, and practices have remained similar to what they were when the company was small. Therefore, the transition to Stage 3 often comes with the owner's realization that he or she can no longer control and manage it all.

Stage 3: Organizational Development

rockstar

Case Study: Professionalizing Rockstar

Based on the action plan provided to the company by IFC Corporate Governance Services, Rami has taken action to professionalize Rockstar as he pursues his vision for dramatic expansion. Heeding his son's advice, he has relinquished operational control of the company to his new chief operations officer, Mariam Awad. He can now focus on what he does best—design—as well as on developing Rockstar's long-term strategy, giving Mariam and her executives full responsibility for operational decision making. With a more collaborative approach to management, Mariam meets weekly with her team, ensuring effective communication across departments.

Rockstar's internal controls have also been substantially upgraded, including the introduction of inventory and sales monitoring and a dashboard system that allows Rami to get a high-level snapshot of the company's performance.

Three years after Rami started professionalizing the business, he successfully negotiated a much needed investment from Sandstone Equity Group. It provided the capital, as well as business connections, necessary for expansion.

In **Stage 3: Organizational Development**, SMEs are working on professionalizing their ***structure and processes***, after having passed through the period of initial growth in Stage 2.

Characteristic at this stage is the increasing need for professional management, specialized expertise, and proper systems and controls. HR becomes strategically important as the SME aims to hire professional staff and optimize organizational structure and policies.

Risks for the enterprise

At this stage, the company is coming off of a dramatic growth period, with largely expanded staff and product offerings, but its internal structure, policies, and processes remain rooted in the start-up stage. Therefore, this stage lends itself to many inconsistent practices. For example, incentive systems may not correlate with the company's performance, and policies often are not followed or sometimes are excessive.

This stage is often very hard for the entrepreneur, as it requires good management and administrative skills, in addition to entrepreneurial skills that fueled the company at Stages 1 and 2. It is possible to be a great entrepreneur and bad administrator, and vice versa.

Staff-related issues are common. Professionalization of management may lead to conflicts between "old" and "new" teams. Ongoing organizational, staff, and operational changes may affect employee morale and motivation. As the business begins to operate less on personal relationships and more on defined policies and procedures, some may find the transition difficult.

SMEs in this stage may experience frequent power shifts or changes in key management positions; decentralization and delegation may be unstable or unclear. Checks-and-balances risks may include the lack of controls and accountability and an excessive focus on process.

Risks for investors

In this stage, investors are wary that the professionalization is not complete and *personal* relationships prevail. It can also happen that, despite having formal checks and balances in place, there is the risk of continued direct interference by the founders to "check and control" the business, bypassing the new structure and policies in the process. The focus on internal development can—and often does—lead to a slowdown in growth and decision making. Another possible red flag is family members crowding out professional staff.

Conflicts may arise between founding partners, new management, and investors, which can be heightened by poor communication between these parties.

Focus of mitigating actions

Governance practices support the need for good administration, documentation of processes and procedures, structured decision making, and professional management. The owners must

either develop management and administration skills or hire and empower people who have them, such as a chief operations officer.

Overall, the decision making needs to become more decentralized and **collaborative**. For example, an executive body, often called the executive board or committee, meets regularly to coordinate activities and help the CEO handle operational decision making, and to provide periodic input into strategic decisions. Also, a formalized advisory board may support the owner/CEO on strategic issues.

Systems that provide proper checks and balances need to be formalized, and the company should establish an internal audit function.
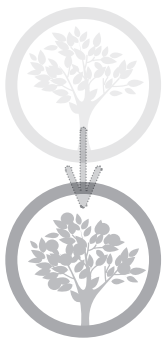
Stage Transition: Stage 3 to Stage 4

With systems and processes in place, good administration, and professional management, a Stage 3 SME is now a more professional business and is ready to focus on further growth. Internal capacity itself, however, is not enough for business expansion: the company needs capital. This prompts many entrepreneurs to reach out to external investors—either related, such as family and friends, or professional, such as private equity funds. New shareholders will require effective governance mechanisms—such as a functional board of directors—for the control and direction of the company. Stage 3 focused on improving management; in Stage 4 the emphasis is on governance.

Another driver for stage transitioning might be that the founder is getting out of the active management role for personal or business reasons—to start a new company, to hire a professional CEO to manage further business expansion, to pass the baton to the next generation, and so on. Even if the business remains in the same hands, the need for better governance may arise.

Finally, businesses increasingly choose to establish a board of directors and other governance mechanisms, even if no change in ownership structure is imminent. They realize that a professional board brings valuable expertise, diverse perspectives, and business connections—crucial ingredients for sustainable growth.

rockstar

Case Study: Rockstar Business Expansion

In the famous founder's dilemma, "to be king or to be rich" (Wasserman 2008), Rami chose the latter. Instead of tightly holding onto a small company, he opted to fuel the growth with external investors and cash in. Rami, now retired, is no longer involved in the day-to-day operations of the company but rather sees the years he invested in the organization reflected in his dividends and rising value of the company.

Rockstar Clothing Company has become an institution with defined governance processes and procedures. The board of directors has fully taken up its role of providing strategic oversight, and Mariam, formerly the COO, has been promoted to CEO. Sandstone's representative now has a seat on the board of directors. Rami continues to chair this more professional board, as he and his family members remain controlling shareholders.

With all systems and controls in place, including having external auditors providing third-party assurance, the business has achieved more than Rami had envisioned. He's especially proud of his grandson, Asaf, who was hired by the company after completing his college degree. Rami hopes that one day a member of the Bahgat family will again be at the helm of the organization. However, with the new employment policies, Asaf will have to work his way up—like any other high-potential employee.

In **Stage 4: Business Expansion**, SMEs start resembling large companies in business structures, management, and governance practices. The decision-making style within the organization can be defined as institutional, and companies enter the territory covered by the traditional connotation of "corporate governance."

Risks for the enterprise

Too much administration, with decision making concentrated on processes and not on growth, runs the risk of bureaucracy. Increased reliance on hard, measurable data minimizes the role of judgment and can adversely affect decision making and agility. Management may become risk

averse, reducing entrepreneurial drive, innovation, and creativity. There also is a risk of increasing overhead as a percentage of revenues.

Risks for investors

In Stage 4, there is the risk that the professional management team that the company hired is just "window dressing," with control still resting with founders and family members. If suitable assurance is not in place and not independent of management, investors will be wary.

Tensions may arise from unequal treatment of shareholders and employees—for example, between family members and non-family members.

For family-owned SMEs, the company may lack a clear strategy to distinguish between employment and ownership, leading to growing tensions within the family as well as the business.

Focus of mitigating actions

The practices presented for this SME stage provide support for building "traditional" corporate governance structures and policies (such as a board of directors) to balance interests of various shareholders, to bring in new expertise and perspectives, and to support development of long-term strategy. If there is a change in ownership structure, external investors will expect to have a "seat at the table"—representation on the board of directors—which of course will influence how the company is managed.

External investors and professional boards require strong risk management, good internal controls, and reliable financial and nonfinancial reporting.

Tool: Identifying My Company's Stage of Evolution

Table 2.1 summarizes the evolution of SME governance over the four stages of SME growth. When using it to identify your company's stage of growth, please keep in mind that the elements in each stage (column) are interrelated; so if a company is between stages (or has features of several stages), it is important to select the **earlier stage** designation as the **primary SME stage**. You need to address the risks in the lagging categories (from the earlier stage) before moving to the requirements for the next one.

Table 2.1 assumes that investors are most likely to join the company when it has demonstrated its potential for growth—Stage 3, or late in Stage 2. The entry of external investors has a profound impact on how the company is governed and managed. However, investors can enter at any stage, including Start-Up, which would typically imply an accelerated push toward Stage 4 regarding the key governance practices. (**For more on the investor's perspective on SME governance, see Box 3.2 on page 39.**)

Evolution of SMEs

Defining Factors/ Parameters	Stage 1 START-UP	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
Size* (# of employees)	Small (e.g., <50)	Small to Medium (e.g., 50–75)	Medium (e.g., 76–150)	Medium Growing (e.g., 151–250)
Enterprise Focus	Developing products, testing the market	Sales and growth, increasing variety of products, creating client base	Optimizing own structure/processes after growth	Further growth, supported by improved internal organization and processes
Culture and Commitment to Good Governance (Policies, processes, and organizational structure)	▶ Small multitasking team ▶ High degree of informality ▶ Few systems, established "on the go"	▶ Team is growing—distinct functions and organizational structure start emerging ▶ Simple systems to enable functions to collaborate	▶ Increased professionalization of functions ▶ Formalizing organizational structure, policies, and procedures	▶ Continuation of trends started in Stage 3
Decision Making and Strategic Oversight (Decision-making process and bodies, leadership style.)	▶ Highly centralized decision making by the founder(s) ▶ Autocratic leadership style	▶ Emergence of delegation to management ▶ Consultative leadership style—largely autocratic but with input from key managers and advisers	▶ Professional managers are hired ▶ Decentralization of authority through division/ functional management ▶ Collaborative management style	▶ Separation of strategic and operational decision making ▶ Institutional decision-making style, based on defined org. structure, roles, and procedures
Risk Governance and Internal Controls (Internal checks and balances)	▶ Founders are fully involved in operations—limited need for checks and balances	▶ Introducing internal controls to support delegation of authority	▶ Detailing authorities and accountability ▶ Systems are formalized and automated ▶ Developing practices to control main operational risks	▶ Focus on proactive and strategic risk management
Disclosure and Transparency (Communication with internal and external stakeholders)	▶ Everyone knows everything	▶ Silos—good within, but challenging between silos ▶ Basic external info shared on products offered	▶ Internally: improving cross-divisional / functional information sharing ▶ Enhanced external business-related information	▶ Internally: management, board, and shareholders communicate ▶ Externally: targeted information for different stakeholders
Ownership (Founders/ Shareholders/Family)	▶ Single owner or couple of individuals ▶ Founders personally control every aspect of business	▶ New minority shareholders possible (internal or related) ▶ Founders remain dominant and fully engaged ▶ Increasing number of family members getting involved in operations	▶ New minority shareholders possible (internal or related) ▶ New investors informally influence strategy but are not directly involved in operations ▶ (If a major investor enters, company moves to Stage 4)	▶ Common options: a. Founders, private equity, and other investors b. Growing family ownership/ generational change c. Go Public (IPO) ▶ Investors require tools for control and direction of the company.

* May vary by industry, so this guidance is intended to be broadly indicative.

SME Governance Framework

2

SME Governance Matrix: Identifying Recommended Actions for My Company

At the end of this section, you will be better able to do the following:

▶ See how cumulative governance recommendations address enterprise risks at each stage.

▶ Understand the big picture of how governance evolves together with the company.

The SME Governance Matrix is a comprehensive framework that aims to address typical risks for the enterprise and its investors at each stage of SME development. The idea is to help a company develop smoothly and gradually, always focusing on what is appropriate at its given evolutionary stage. The Matrix summarizes key mitigating actions along the following five key governance topics:

A **Culture and Commitment to Good Governance** covers owners' awareness, demonstrated commitment, and values, such as having an organizational structure and key policies and processes in place.

B **Decision Making and Strategic Oversight** demonstrates how decision making needs to evolve from a one-man show to become collaborative and institutional. It introduces the instruments for organizing the management team—and later the advisory board and the board of directors. Human resources and succession planning also need to be addressed here, because SMEs typically have few decision makers, which presents a high key-person risk for the company.

C **Risk Governance and Internal Controls** starts with the big picture—the overall control environments as indicated by the company's culture and values—and considers specific

issues related to risk management and control, cash flow management, information technology (IT) management, and internal and external audits.

D **Disclosure and Transparency** covers both financial and nonfinancial disclosure to investors and other key stakeholders.

E **Ownership** addresses the policies and mechanisms that support the rights and responsibilities of shareholders. It includes the rights of founders and family members, organization of the annual general meeting, and shareholder dispute resolution.

The five topics covered in the SME Matrix draw on the IFC Corporate Governance Framework, which has been adopted by more than 30 development finance institutions worldwide. The IFC Corporate Governance Framework, in turn, is based on the OECD[8] Corporate Governance Principles (OECD 2015). Therefore, SMEs working with the IFC SME Governance Framework will be able to naturally graduate into "corporate" governance as they become large companies.

It is important to keep in mind the following points:

▶ **Table 2.2** is an abbreviated version of the Matrix, providing a general overview (details provided in Chapter 3).

▶ The recommendations for each topic are cumulative— they build on the actions of the previous stages.

▶ The contents of the five governance topics for each stage are designed to be interdependent and mutually reinforcing. A company should move through the Matrix column by column. It is important for the five topics in each given stage be addressed before the company embarks on the next stage, to ensure that the associated risks are addressed.

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8   OECD = Organisation for Economic Co-operation and Development.

SME Governance Matrix

Key Governance Topics	Stage 1 START-UP BUSINESS	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
A Culture and Commitment to Good Governance	▶ Core functions identified ▶ Articles of association adopted	▶ Core positions filled ▶ Organization chart, key policies, and statement of basic business principles	▶ Governance champion ▶ TORs for key positions ▶ Core processes documented ▶ A calendar of corporate events	▶ Governance action plan ▶ Company secretary function ▶ Governance provisions incorporated in the articles of association and bylaws
B Decision Making and Strategic Oversight	▶ Informal external advisers involved* ▶ Founder(s) make decisions in consultations with individual executives ▶ Authority limits of key personnel have been communicated	▶ External advisers formally engaged ▶ Key decisions are made in collaboration with executives as a group ▶ Limited delegation of signing authority formalized ▶ Staffing priorities identified ▶ Business continuity plan for CEO and key persons	▶ Continuous and structured outside advice is engaged ▶ Enterprisewide discussions on strategy, financing, staffing ▶ Executive/management (or similar) committee formalized ▶ HR policies to attract, retain, and motivate staff ▶ Succession planning framework for key persons	▶ A board of directors ▶ Board procedures ensure effective meetings and input from all directors ▶ Succession-planning policy has been approved by the board
C Risk Governance and Internal Controls	▶ Basic bookkeeping, cash flow management, and tax functions ▶ Cash sources, bank accounts are separate from those of the founder(s) ▶ Basic understanding of regulatory requirements and compliance	▶ Basic principles of business conduct ▶ Basic business risks—including key-person risks—identified ▶ Processes in place for tax payments, records, and filing ▶ Controls on cash management	▶ Detailed code of ethics and business conduct ▶ Objectives, strategic planning, budget, KPIs, and clear accountabilities ▶ A professional CFO ▶ A basic internal audit function ▶ Policies and procedures to monitor and mitigate strategic and operational risks ▶ Business units have clear authority, reporting lines, and guidelines	▶ Effective internal controls systems (e.g., based on COSO) ▶ Independent external auditors ▶ Timely and secure recording and reporting for sales and accounts
D Disclosure and Transparency	▶ Basic financial accounts prepared ▶ The same financial information and data are used for all purposes	▶ Monthly bank account reconciliation disclosed to all founders ▶ Founder(s), shareholders, and directors periodically receive consistent financial and nonfinancial information ▶ The public profile of the enterprise has been developed	▶ Financial statements in accordance with national accounting standards ▶ Point person for information sharing identified ▶ Key decisions are formally communicated to all staff ▶ Basic performance reports are presented to external advisers ▶ Key nonfinancial information is disclosed to the public	▶ Financial reporting for SMEs is in accordance with the IFRS or U.S. GAAP (if having/seeking foreign investors) ▶ Financial statements are audited by a recognized auditing firm ▶ Quarterly financial reports and comprehensive performance reports are provided to investors ▶ An annual report (or equivalent) is produced. Shareholders are provided with information on request
E Ownership	▶ The role and responsibilities of the founder(s) clearly established ▶ Basic understanding of roles of all founding family members ▶ Shareholder dispute resolution mechanism	▶ The difference between non-family and family issues is acknowledged ▶ Awareness of family succession planning ▶ Annual shareholders' meetings	▶ Clear distinction between the roles of the founder(s), family members, and managers ▶ Clear career paths for non-family executives ▶ Family succession plan ▶ Annual shareholders' meetings include discussions of key decisions made, dividends, and plans	▶ Policies and mechanisms to regulate family members' ownership, employment, and other benefits ▶ All shareholders are regularly updated on company policy, strategy, and results ▶ Mechanism for resolving governance-related disputes

* Some jurisdictions require a board of directors at the time of company registration. Such boards are often just a formality. This Matrix does not assume the board to be effectively functional until Stage 4.

SME Governance Framework

2

▶ The table is generalized for all markets and types of companies. Its relevance for specific companies may vary. Use your judgment and/or professional advisory services to identify recommendations relevant for your company.

▶ The Matrix acknowledges that the family of the founders is an important factor to be addressed, regardless whether the SME considers itself a family business.

▶ Some of the issues addressed in the Matrix, especially at Stages 1–3, relate more to management than to what is traditionally understood as "governance." This is intentional. Certain management issues need to be addressed before governance can start to be effectively implemented. These might be called "*pre-governance*" issues.

To illustrate the cumulative nature of the recommended practices, let's look at the key governance topic **A. Culture and Commitment to Good Governance.**

For this governance topic, a Stage 3 SME would consider the following leading practices for Stage 3 (building on the two previous stages): articles of association adopted; core functions identified; core positions filled; organization chart, key policies, and statement of basic business principles adopted; governance champion identified; TORs (terms of reference) for key positions developed; core processes documented; and a calendar of corporate events adopted.

Also, given that the governance topics are interdependent, these practices for improved **Culture and Commitment to Good Governance** must be accompanied by the related practices for the other four governance topics. For example, a company in Stage 3 will see increased delegation (**B. Decision Making and Strategic Oversight**), which must be supported by improved internal controls (**C. Risk Governance and Internal Controls**) for effective accountability.

NEXT: *Chapter 3 "expands" the SME Governance Matrix. It provides a detailed explanation of each governance topic and discusses related recommended actions in more detail.*

Chapter 3

Key Governance Topics
and Leading Practices

3. Key Governance Topics and Leading Practices

At the end of this chapter, you will be better able to do the following:

▶ **Understand key governance topics and related concepts.**

▶ **Learn about stage-appropriate governance practices for your company.**

THIS CHAPTER looks into select governance concepts and practices presented in the IFC SME Governance Matrix (***shown in Table 2.2 on page 23***). These leading practices lay the groundwork for action planning. SME owners will be able to see what elements are missing or lagging and can plan the actions necessary for building a more resilient SME from the perspective of good governance.

NOTE: The Appendix of this Guidebook provides worksheets to support this process.

A

Culture and Commitment to Good Governance

"Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flows towards companies that practice this type of good governance."

— Mervyn King, Chair, King Report

Stage 1 START-UP BUSINESS	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
▶ Core functions identified ▶ Articles of association adopted	▶ Core positions filled ▶ Organization chart, key policies, and statement of basic business principles	▶ Governance champion ▶ TORs for key positions ▶ Core processes documented ▶ A calendar of corporate events	▶ Governance action plan ▶ Company secretary function ▶ Governance provisions incorporated in the articles of association and bylaws

The SME owner needs to demonstrate that corporate governance is important and integral to the company's sustainable development. This should be done through addressing the following topics:

▶ **Owner's Awareness and Commitment to good governance**

▶ **Appropriate Organizational Structure**

▶ **Key Policies and Processes**

Owners' awareness and commitment starts with the owners' demonstration that they are ready to play by the rules through basic formalization of business in Stage 1. As the company becomes more complex, there is increased emphasis on formalization of processes and on setting the right vision and culture for the company.

Similarly, organizational structure can be very informal at the Start-Up stage and then evolves into a formalized structure with authorities and responsibilities defined by appropriate policies and processes.

Owners' Awareness and Commitment

The ultimate success or failure of the business is highly dependent on how the owner develops needed skills and adjusts his or her priorities as the business grows. Here are some contributing factors (Churchill and Lewis 1983):

▶ *Owner's goals* shift from a personal focus to sustainability and profitability.

- *Owner's operational abilities* shift from directly managing all operational matters to overseeing and supervising operational matters.

- *Owner's managerial ability* shifts from command and control to leadership.

- *Owner's vision* shifts from the short term to the ability to reconcile long-term strategies with implementation constraints.

As a business moves from one stage to the next, the changing nature of these managerial challenges becomes apparent.

Typically in a Stage 1 SME, the owner *is* the business. The founder is both a visionary entrepreneur and a "jack of all trades," operating with few or no formal procedures and with the support of family, friends, and a few dedicated employees. Start-ups are built on the owner's dreams and talents: the ability to sell, produce, invent, innovate, or create. The owner's ability to delegate is not a priority.

If the vision of the owner and the conditions are right, then the business will experience growth. As the business continues to grow, so will the level of complexity, resulting in the need for the owner to increase the level of skills and competencies of the staff. Soon enough, the skills and competencies of the staff will match or even surpass those of the owner.

During this growth, the owner has to make the transition from "doing work" to providing entrepreneurial strategic leadership and "getting work done" through others. The owner must realize that the business has grown beyond him or her and must learn to delegate to specialists and other managers, accept advice from outsiders, and move the decision process from individual to more collegial. In fact, the inability of many owners to let go of *doing* and to begin *managing and delegating* is a major reason for the failure or stagnation of many businesses before they reach Stage 3.

This evolution of the role of the business owner from operational management to strategic leadership requires the owner to create and empower the appropriate management and governance bodies

(discussed in **Decision Making and Strategic Oversight starting on page 34**), and to support professionalization of the business through developing its organizational structure as well as appropriate policies and processes.

Organizational Structure

Organizational structures vary considerably, depending on the industry, the sector, and multiple other factors. The following are two overarching organizational circumstances that support successful SME evolution:

- Companies evolve from fluid and highly centralized organizational structures to well-defined and decentralized firms, with clearly defined roles, responsibilities, reporting lines, and authorities.

- Processes change from supporting multitasking teams to supporting defined, specialized functions and collaboration among them.

In recent years, the field of research in organizational structures has evolved and has developed several innovative propositions to help companies improve their performance. As our focus here is on corporate governance, we emphasize one factor: the need for a dedicated governance champion to establish and manage the policies and systems for good governance.

In the early days of an SME, the owner/CEO should have the role of champion, especially when it comes to communicating the importance of good governance to staff and articulating key principles of business conduct. As companies approach Stage 3, however, this role will increasingly require specialized expertise and good administrative skills. That's when it makes sense to appoint a dedicated executive or the company's lawyer to perform this function. As the company matures into Stage 4, a fulltime position for a governance champion might be warranted; this position is typically called the **company secretary** (also known as corporate secretary, governance professional, or corporate officer in some markets).

The company secretary's duties are wide-ranging and typically include the following:

▶ **Scribe:** taking minutes during board meetings.

▶ **Compliance officer:** (optional) being responsible for ensuring that the business complies with all its legal and regulatory requirements.

▶ **Adviser and confidante to the board** in general and to each individual director, including the chair, on all matters of governance. The company secretary should provide advice on many issues, including, among others, conduct of meetings, board succession, appointment and removal of directors, conflicts of interest, and trends in governance.

▶ **Educator and governance leader:** taking the lead on issues related to governance, such as ensuring the adequacy of the governance frameworks. Together with the chair, the company secretary should ensure that new directors are properly inducted into the organization and that there is an adequate and meaningful ongoing professional education program for directors.

▶ **Liaison between board and management:** The company secretary is in a unique position to facilitate information flows between the board and management. For example, the company secretary coaches management on meeting the board's expectations regarding information and on behaving appropriately within a board setting. The company secretary also plays a key role in communicating information from the board to management.

▶ **Shareholder and other stakeholder relationships:** The company secretary plays a pivotal role in ensuring proper communication and education, especially in relation to annual general meetings. The company secretary may also be responsible for other stakeholder relationships, including those with key regulators.

Key Policies and Processes

Most governance-related recommendations on policies and processes[9] deal with specific topics, such as human resources, internal controls, decision making, and so on, and will be discussed in relevant dedicated sections of this chapter. In the context of key policies and processes, the practices described below focus on the following:

▶ Raising awareness on the commitment to good governance throughout the company, to staff, shareholders, and other stakeholders, through key company documents, such as articles of association, and internal documents;

▶ Ensuring high ethical standards of doing business, by setting the tone at the top and disseminating a culture of ethics throughout the company; and

▶ Supporting an increasingly decentralized business structure by ensuring that there are proper communication mechanisms and processes for sharing information between units and departments.

A **LP**

Leading Practices:
Culture and Commitment to Good Governance

Below, we present leading common practices for each SME's evolutionary stage, using the categories discussed above:

▶ **Owners' Awareness and Commitment**

▶ **Organizational Structure**

▶ **Key Policies and Processes**

Note that these practices are cumulative: practices for later stages build on the practices of earlier stages. Some recommendations may be implemented more effectively in different stages, depending on circumstances, or may be implemented as the company is transitioning from one stage to the next. Use your judgment to determine the best timing for your company.

Stage 1: START UP BUSINESS

Owners' Awareness and Commitment

Officially register the business with proper authorities (as a company or sole entrepreneurship) to ensure separation of the business from the person.

Organizational Structure

Identify core business functions needed, and distribute them among your multitasking team. At this initial stage, the company is too small for separate departments and divisions, but it is important to identify the core business functions that need to be managed, such as finance, HR, marketing, and administration. Assigning responsibility for these functions to team members increases accountability and facilitates clear communication.

Key Policies and Processes

Adopt the articles of association and any other relevant policy deemed necessary to provide a minimum structure to regulate the distribution of tasks.

Stage 2: ACTIVE GROWTH

Owners' Awareness and Commitment

Develop a basic statement on vision, mission, and core values and communicate it to staff. Engage your staff in developing this document, so they feel a genuine sense of ownership in the company and its future. This statement will also be important in motivating your staff, especially senior management (**see *Maximizing motivating factors* on page 46**), and establishing an effective system of internal controls (**see *Elements of Internal Controls* on page 53**).

Organizational Structure

Ensure that the core functions needed for the company to grow have been filled through direct hiring or outsourcing.

Develop clear job descriptions. Remember to include management/reporting responsibilities—identify whether this position has direct reports and where it fits on the company organizational chart, and be sure the description is clear regarding accountability (deliverables/results).

Define, document, and communicate to all staff the organizational structure, with lines of authority and reporting. Share this information with staff as part of the onboarding process for new employees. Changes that significantly affect individual employees should be shared on an individual basis.

Key Policies and Processes

Develop or further enhance basic policies, where applicable, to regulate the authority/function. These policies are key elements of an effective system of internal controls (**see *Elements of Internal Controls,* page 53**). Regarding policies and processes, managers should have ongoing responsibility for monitoring the practices of the staff under their direct supervision. Develop a process of periodic discussions with managers to assess the efficiency of the monitoring process and gauge the practices of employees. If needed, take corrective actions to improve either policies and processes or practices.

Stage 3: ORGANIZATIONAL DEVELOPMENT

Owners' Awareness and Commitment

Signal the intent to develop effective governance by discussing its importance with managers and staff. For a business to practice good governance, everyone has to be on board. It is also key that the right tone is set at the top, through policies, actions, and communication. In meetings,

take the time to talk about good governance and its benefits—to increase awareness and commitment to implement leading practices.

Articulate and regularly communicate the long-term vision for the company. It will inform management decisions, guide strategic planning, and serve as a motivational factor for staff.

Organizational Structure

Appoint someone to be responsible for improving governance practices and compliance. This could be a fulltime position (company secretary) or part-time function for one of the executives or a lawyer.

Conduct periodic reviews to evaluate the company's organizational structure and reporting lines. The organic growth of SMEs may call for these reviews to be more frequent. Include these reviews as part of the strategic review process, and ensure that any changes are communicated to staff in a timely fashion.

Key Policies and Processes

Document and regularly review the efficiency of core processes (accounting, procurement, and so on). Consider whether it makes sense to appoint a person to formally monitor, at the level of the whole company, adherence to policies and processes. Establish a formal process of communication between the person in charge of monitoring and the rest of the company, namely managers, executives, and the owners.

Start producing a simple calendar of company events (team meetings, participation of company representatives in conferences and public forums, and so on).

Stage 4: BUSINESS EXPANSION

Owners' Awareness and Commitment

Establish the company secretary function to ensure effective work of the board, to help the board improve governance practices and compliance, and to organize annual shareholder meetings.

Organizational Structure

Establish the board of directors to perform the key functions of strategic advice and oversight.
(**See *Board of Directors*, page 37.**)

Key Policies and Processes

Develop an action plan that includes explicit actions, timing, and responsibility to improve governance.

Formalize governance provisions, with participation of all shareholders and key stakeholders. Include these provisions in the articles of association, shareholder agreement, and employee handbook. (Sometimes also known as a staff manual, the employee handbook is given by a company to all employees and typically includes information about company culture, policies, and procedures.)

B

Decision Making and Strategic Oversight

"It doesn't make sense to hire smart people and tell them what to do; we hire smart people so they can tell us what to do."

— Steve Jobs

Stage 1 **START-UP BUSINESS**	Stage 2 **ACTIVE GROWTH**	Stage 3 **ORGANIZATIONAL DEVELOPMENT**	Stage 4 **BUSINESS EXPANSION**
▶ Informal external advisers involved* ▶ Founder(s) make decisions in consultations with individual executives ▶ Authority limits of key personnel have been communicated	▶ External advisers formally engaged ▶ Key decisions are made in collaboration with executives as a group ▶ Limited delegation of signing authority formalized ▶ Staffing priorities identified ▶ Business continuity plan for CEO and key persons	▶ Continuous and structured outside advice is engaged ▶ Enterprisewide discussions on strategy, financing, staffing ▶ Executive/management (or similar) committee formalized ▶ HR policies to attract, retain, and motivate staff ▶ Succession-planning framework for key persons	▶ A board of directors ▶ Board procedures ensure effective meetings and input from all directors ▶ Succession-planning policy has been approved by the board

* Some jurisdictions require a board of directors at the time of company registration. Such boards are often just a formality. This Matrix does not assume the board to be effectively functional until Stage 4.

This section addresses the strategic stewardship of the company and the role of decision making in determining its future:

▶ **Management Decision Making**

▶ **Advisers/Advisory Board**

▶ **Board of Directors**

▶ **Succession Planning**

▶ **Human Resource Planning**

SMEs need to gradually transition decision making from highly *centralized* (the owner) in Stage 1 to more *distributed and collaborative*, relying on a professional executive team and trusted external *advisers* (or *advisory board*). Later, select advisers may be invited to serve on the *board of directors*, formed at Stage 4, to provide guidance to and oversight of the executive team.

At the same time, owners have to ensure that the business has the "depth" of expertise required to take it into the future. This can be achieved through the development of appropriate *human resources* policies, including *succession* plans. These policies evolve from

a focus on addressing immediate business needs and ensuring business continuity (at the early stages) to comprehensive approaches to human resources to support the strategic development of the company (starting with Stage 3).

Management Decision Making

It is common practice in the start-up stage for an SME founder/CEO to be the sole decision maker—or with only one or two key trusted insiders or outsiders consulted occasionally. This concentrated decision-making process might be justified at the start-up stage, when the founder is establishing the company vision. However, it brings with it a high probability of less-than-optimal decisions, largely due to various personal biases as well as narrow perspective and expertise.

The decision-making style needs to evolve with the company. Successful leaders not only empower talented managers to excel in their areas of direct responsibility but also encourage them to work collaboratively as a team.

Delegation: As businesses start to grow, effective delegation becomes increasingly important. Research shows that a founder's inability to delegate is one of the most common barriers to the growth of an SME into a larger business.

A 2014 Gallup survey of the business performance of 143 CEOs of the sample of 500 fastest-growing companies in the United States found that CEOs with a high level of delegation talent posted an average three-year growth rate 112 percent higher than CEOs with low talent for delegation (Bharadwaj-Badal and Ott 2015). (**For Gallup's guidance on effective delegating, see Box 3.1.**)

Box 3.1: Qualities of Good Delegators

The following are qualities of leaders with strong delegatory talent:

▶ **Willing to relinquish control and hand tasks to others. This frees up their time to focus on activities that can yield the highest returns for the company.**

▶ **Develop team capacity, using a strengths-based approach. They take the time to understand what their people naturally do best, and then position them to take on tasks at which they are most likely to excel.**

▶ **Ensure that employees have everything they need to do their jobs. They provide employees with tools, resources, training, and learning opportunities; they genuinely care about each employee's growth.**

▶ **Focus on outcomes, not processes. They set clear expectations about everything from timing to budget to deliverables, and then monitor progress.**

▶ **Encourage new ideas and approaches to accomplishing goals. They foster psychological ownership and engagement among employees by giving them autonomy to achieve their goals.**

▶ **Communicate frequently with employees. They provide feedback about what works and what doesn't.**

Source: Condensed from Bharadwaj-Badal and Ott (2015).

Collaborative decision making: As the business becomes more professional and acquires a cadre of competent management, which usually happens late in Stage 2, it is time to start developing a more collaborative approach to decision making.

Some of the benefits of a collaborative decision-making style are related to the positive effects of synergy. Combining the talents and experience of a number of people—with a variety of perspectives on an issue—can lead to alternative solutions that might never occur to one person working alone. As a bonus, when a team tackles an issue and arrives at a solution together, the result is better comprehension and acceptance of the final decision.

The collaborative approach also fosters a sense of common purpose and commitment to the organization, because all management team members have a say in the future direction of the company.

A good mechanism for implementing such decision making in the company is an executive committee (also known as ExCom or management committee). Key participants usually include the CEO/founder, finance manager/CFO, product/service manager, marketing and sales managers, and administration/HR manager. Occasional invitees, when needed, may include key technical specialists, functions related to internal controls, external advisers and experts, and key managers' assistants or temporary replacements (for succession planning).

The executive committee typically evolves through the stages of SME development: At Stage 2, a group of executives forms and meets periodically to discuss current operational matters. (Strategic issues may be addressed from time to time, but such discussions are typically unstructured and unplanned.) This takes the form of operational briefings and typically happens every week or so. Most companies have some form of such meetings. At Stage 3, the executive committee is formalized as a management body with an agenda, procedures, authority, and so on. In the absence of a board, the committee takes on both strategic and operational decision making. By Stage 4, a formal board of directors assumes the role of strategic oversight, with input from the executive committee.

This progression allows the company to evolve its approach to strategy from pursuing the broad vision of the founder in Stage 1, to chasing opportunistic strategies in Stage 2, to deliberate and institutionalized strategic thinking in Stages 3–4.

The decision-making style of the executive committee varies widely between companies—and even from decision to decision within the same company. The CEO remains the chief decision maker but might choose to consult colleagues on some decisions. For decisions involving areas where others have better expertise or where everybody's full commitment is important, the CEO might choose to make decisions by consensus or majority vote. With time, good executive committees develop formal decision-making rules for different types of business areas, to clarify expectations, authority, and responsibilities.

TIP: Normally, weekly management meetings are consumed by urgent operational issues, and people have little time to focus on topics of strategic importance—too many moving parts to attend to, too many fires to put out. Therefore, special arrangements need to be made for strategy meetings. Some companies have special executive committee meetings, dedicated exclusively to *strategic* issues, every 3 to 6 months. They may even alter the setting for such meetings (place, time) to change the routine. For example, these may be called *strategic retreats* and held outside the company premises.

Advisers/Advisory Board

External advisers (trusted fellow entrepreneurs, mentors) can be highly beneficial in the early stages of SME development. They can provide expertise that the company may lack in certain areas, unbiased advice, and external perspectives free of conflicts of interest—as well as new business connections.

When the law or investors require companies to create formal boards of directors, entrepreneurs in the early stages tend to create closely controlled boards. Such boards fail to provide the desired independent advice and oversight. This often leads to the formation of an advisory group (to fill the void), which then coexists with the ineffective board.

Even though individual advisers provide more flexibility and require fewer resources, there are advantages to a more formalized advisory board in the middle stages of development (Stages 2–3):

▶ It is easier to attract high-level specialists: "member of the advisory board" sounds more prestigious than "an adviser."

▶ A group setting brings structure and discipline to the process and harnesses the power of synergy.

▶ An advisory board is a very flexible solution: it may be a temporary or long-term institution.

▶ The advisory board provides a safe way to test the waters for setting up a proper board of directors.

The most practical size for an advisory board is three to five members. People with conflicts of interests *should not* be part of this board. These may include suppliers or vendors to the company, family or friends with no relevant expertise to offer, and providers of services to the company, such as bankers, lawyers, external auditors, and consultants.

In most jurisdictions, members of an advisory board do not assume legal responsibility for operations, as shareholders retain full control of what type and amount of company information to share and how to use the advice given by the advisory board. The advisory board should establish effective meeting processes, similar to those outlined for the board of directors below.

Advisory board members may provide their services free of charge. However, the company should consider

remuneration, as it will attract better candidates, and it also will provide better incentives to actively contribute. The payment can be provided on a fixed annual retainer plus an additional stipend for each meeting attended, which allows for consultation on issues between meetings.

TIP: How do you differentiate between the need for hiring a consultant company and having an advisory board? Consulting is typically considered a process to help a company uncover a specific problem, arrive at a solution, and (often) implement that solution. The input provided may not always be fully unbiased, as it can affect the fees the consultants receive. A typical example: A consulting company advises a company to undertake a particular M&A (merger and acquisition) and then gets hired again to help implement that same M&A. By contrast, advisers help uncover problems and may provide general recommendations, but then they direct their clients where to go for more detailed help. Plus, advising is usually a longer-term relationship and not so affected by conflicts of interest. The bottom line: advising and consulting are not mutually exclusive but rather are complementary.

Board of Directors

A formal board of directors is the definitive means for engaging external expertise, setting strategy, and strengthening the management control function. It is also an important vehicle for SME owners who plan to relinquish their role in active management—for further professionalizing the business or passing it to the next generation. By becoming chair of the board of directors, the founder can have strategic input and retain control of the business without having to be constrained by the day-to-day operations.

Function of the Board: Boards perform two major functions (Monks and Minow 2014):

▶ *Oversight and control*, including, among other duties:

– Reviewing and approving the company's financial standards, policies, and plans;

– Electing and dismissing senior management, especially the CEO;

– Ensuring proper management succession;

– Reviewing results (comparing them with the overall company philosophy, goals, and competition);

– Appraising senior management;

– Ensuring that the company has adequate systems of internal controls, risk management, and compliance.

▶ *Strategic guidance and advice*, including, among other responsibilities:

– Approving and reviewing the company strategy on an annual basis;

– Reviewing and approving the company's long-term goals;

– Assuring that the status of organizational strength and manpower planning is equal to the requirements of the long-term goals;

– Reviewing and approving the company's capital allocations.

Empirical evidence suggests that, for most SMEs, *strategic guidance and advice* has more importance when the business is relatively small, because the owner is very engaged in operations and thus may feel that no external help with oversight and control is needed. As the company grows, the oversight and control function becomes more important.

Board Structure: There are two common board types:

▶ *One-tier or unitary boards* mix non-executive directors with some members of the management team, most typically CEO, COO, and CFO, who are then called executive directors. This governance structure may facilitate strong leadership and efficient decision making. On the downside, presence of management on the board makes it less independent, especially in its core function of oversight.

▶ *Two-tier or dual boards* provide distinct supervisory and management bodies. The former is commonly referred to as the supervisory board, the latter as the management board. Under this system, the company's day-to-day management is given by law to the management board, which is then overseen by a supervisory board that focuses on the company's long-term strategy (elected by, and held accountable to, the shareholder assembly). These supervisory and management boards have distinct authorities; their composition cannot be mixed. For example, the management board's members cannot sit on the supervisory board and vice versa. The advantage of the two-tier system is a clear separation of roles and responsibilities, but it has been criticized for slow, inefficient decision making.

In many countries, the board structure is defined by law or regulations. Other countries allow certain types of businesses to choose. When agency costs and conflicts of interests are high, shareholders may choose the two-tier system. When shareholders and managers trust each other (or when shareholders *are* managers) and the company needs better decision-making efficiency, the owners may choose the one-tier system.

TIP: In countries with two-tier boards, the executive committee can naturally evolve into the management board, and the advisory board into supervisory board.

Board composition: The composition and size of the board of directors depend on the size and complexity of the company's operations. A board of five to seven members works for most SMEs, and even three can be fine to start with. (**See Box 3.2 for investor perspective.**) A typical board has three types of directors:

► *Outsiders*—people who otherwise do not work for the company. Outsiders provide a more unbiased perspective.

► *Independent*—outsiders who do not have material ties to the company's management, shareholders, or other directors. Independent directors are essential for performing oversight functions and providing unbiased advice.

► *Insiders/executive directors*—people who wear two hats, as company employees (typically executives) and as directors. Insiders bring intimate knowledge of company operations.

When considering candidates for board membership, an SME owner should start with the mix of skills, backgrounds, and experiences necessary to meet the business's strategic needs. The mix evolves over time as the company goes through the stages. At any given moment, the company needs to evaluate the skills already represented on the board and identify gaps. The following are among the factors that should be considered:

► *Experience* in key areas (industry, geographical, market, and so on) that will contribute to the company's strategy and growth;

Box 3.2: Investor Perspective

Famed American businessman and venture capitalist Fred Wilson wrote on his blog:

I am a fan of a three-person board early on in a company's life. I generally recommend that a founder put himself or herself on the board along with two other people he or she trusts and respects.

This situation changes a bit when investors get involved. If the founder retains control, then the situation does not have to change. Founders can still nominate and elect the directors they want on the board. However, investors can and will negotiate for a board seat in some situations. This is less common for angel investors and more common for venture capital investors.

Adding an investor director does not mean that the founder loses control of the board. It can remain a three-person board with one investor director and two founder directors. Or the board can be expanded to five, and the investors can take one or two seats and the founder can control the rest. These two situations are common scenarios when the founders control the company.

As a company moves from founder control to investor control, the notion of an independent director crops up. An independent director is one who does not represent either the founder or the investors. I am a big fan of independent directors and like to see them on the boards I am on. Boards that are full of vested interests are not good boards. The more independent minded the board becomes, the better it usually is.

When the founder loses control of the company (usually by selling a majority of the stock to investors), it does not mean the investors should control the board. In fact, I would argue that an investor-controlled board is the worst possible situation. Investors usually have a narrow set of interests that involve how much money they are going to make (or lose) on their investment. It is the rare investor who takes a broader and more holistic view of the company.

So while investor directors are a necessary evil in many companies, they should not dominate or control the board. The founder should control the board in a company he or she controls, and independent directors should control a board where the founder does not control the company.

Source: Condensed from Wilson (2012).

Decision Making and Strategic Oversight

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- *Subject-matter and technical expertise* needed in such fields as finance, legal, IT, and so on;

- *Networks* that bring professional and stakeholder connections to the company;

- *Reputation* that will raise the profile of the company and/or add market confidence;

- *Personal attributes*, such as risk tolerance, willingness to challenge, and other characteristics that will round out the board and strengthen the interaction of its members;

- *Diversity* of views and perspectives, as well as of age, gender, background, and so on.

Finding directors for your board: The two most common ways for companies to find directors are through contacts and acquaintances or through outside independent search options. Most SMEs choose to find directors through existing connections, because the use of referrals tends to increase the company's level of confidence in the candidate as well as its potential control over any confidential information that might be shared with the newly appointed directors. While effective and cost-efficient, this method may limit the ability of the candidate to effectively provide independent and unbiased input to the board; coming from the circle of relationships of the owner, the newcomer might not be inclined to contradict the owner.

Companies interested in finding the most suitable candidate outside of the owners' network can use the services use of executive headhunters, directors' databases, or search engines. Directors found through this means tend to bring more independent and unbiased views to the board. However, for their input to add value, the owner needs to accept the idea of allowing a "true" outsider to take a role on the board of the company, which may take some time.

Director compensation: Remuneration is a complex topic. The owner needs to strike a balance between the need to provide remuneration sufficient to attract and retain

the best candidates and yet not pay them so much that it hinders their ability to remain effectively independent.

A guideline is that a director's time is valued as much as the time of the top executive. Therefore, remuneration should reflect the time spent to prepare for and attend the yearly board sessions, plus coverage of expenses (travel, accommodations, and meals). It may also include long-term payment plans, such as share options, to ensure that board members' interests are aligned with long-term interests of the company.

Board role versus management role: There are many fundamental differences between the role of a director and that of a manager. It is important that these distinctions be clearly understood by both—directors and managers. One of the most useful and important ways to promote accountability and transparency, and to demonstrate commitment to good governance, is to identify and communicate the core functions in the business together with lines of authority.

A guiding principle for the board-versus-management concern is that directors should have their "nose in the business, but their hands out." In other words, directors should let the management team handle the day-to-day operation of the company, while the board maintains proper vigilance and oversight of their activities.

Role of the chair: During board interactions, the chair has a key leadership role in ensuring that all the directors participate in discussions and decisions—that no director dominates and no one is left out. With the help of the company secretary, the chair prepares for and conducts board meetings and coordinates their timing and frequency. The chair also ensures that the board's agenda is appropriate and that meetings stay focused on the key tasks. In particular, the chair makes sure the board monitors the company's progress—but does not slide into managing the business.

The chair must monitor the board's composition and structure—and initiate remedial activity if necessary. The chair is also responsible for inducting new members onto the board.

Some business owners have difficulty adjusting to the role of board chair. As CEOs, they get used to being the direct superiors of other managers in their team. The chair, however, is not "the boss" of other directors on the board but rather is "the first among equals." The chair conducts the meetings so that all members freely share their views. Moreover, a good chair will always aim for a decision based on consensus, not just on majority vote.

Establishing effective board processes: To be of real use to the company, the board of directors must commit to effective working practices. Too often, this very basic issue receives only passing consideration, even though it has a direct, immediate impact on the board's work and effectiveness. The following list sums up some simple good practices:

▶ Define, formalize, and communicate authority and rules of interaction between the board, shareholders, and management.

▶ Set a formal agenda, with input from members:

 – Review *both* past performance and forward-looking issues;

 – Ensure time for strategic discussions, and limit the mundane issues;

 – Ensure proper follow-up, and review progress on previous decisions.

▶ Prepare briefing papers:

 – Keep them short and specific as to purpose (actionable? just for information? and so on);

 – Send to the directors at least five days in advance, so they have time to absorb the information and prepare for the session.

▶ Take and approve minutes (discussions, opinions, and decisions).

▶ Create a board calendar with key issues to be discussed (four to six meetings a year), so important topics are covered and board members can be prepared and can free their time accordingly.

Succession Planning

We define succession planning as the process of identifying and developing people within an organization to fill key business leadership positions in the future or to replace key persons in the event of sudden absence. This is done to ensure business sustainability and resilience in crisis.

The penalty for failing to get ahead of changes in leadership or ownership can be significant. According to research in Asia by a prominent academic, Joseph Fan, in the five years after the company founder turns over the reins to the next generation, companies decline in value by an average of nearly 60 percent (IFC 2017). More than half the value gets wiped out!

SMEs need to be mindful of three types of succession:

▶ **Ownership succession** refers to the person who will take over as the equity holder of the business. This form of succession is especially relevant for family-owned businesses. (**See *Governance Topic E. Ownership*, page 71.**)

▶ **Management succession** primarily refers to the person who will take over the operations and day-to-day activities of the business.

▶ **Specialized expertise succession** concerns people with expertise that is crucial to the business and/or is scarce on the market.

For most SMEs, the ownership and management succession will be interrelated. Founders need to be clear about their long-term business goals, because they directly affect key succession decisions. For example, owners working toward building a business with the hope of eventually cashing out with external investors may opt to transition to professional management. An owner that is focused on building an intergenerational legacy may prefer to develop family management talent.

Once you have some clarity on the long-term goals for your business (typically sometime during Stage 2), it is time to start working on the succession plan. It should

Case Study: Rockstar Succession

Rami's son, Sherif, is interested in keeping the business in the family, but he has said, "I cannot see myself in the future of the company, as I have other interests. I am only here to support my dad during this period."

In light of this, Rami asked a consultant to propose a succession-planning process to address key-person risk within the company. The risks were prioritized as follows:

▶ **High priority & urgent: designer (specialized succession).** Design is what gives Rockstar its competitive edge, but Rami remains its only designer. An apprentice needs to be hired and properly trained.

▶ **Medium term: CEO.** The growing company needs a CEO with managerial talent, which the founder lacks. The founder's son has no interest in running the company, and there are no obvious successors within the current company ranks.

▶ **Medium to long term: ownership.** To prepare his son for the role of the business owner, it might be advisable to invite him to the board and engage him in strategic decision making.

move from "a thought in the back of the owner's mind" to a clear plan that has been shared with every key person in the business and other stakeholders.

According to PwC's survey of family businesses in the United States, just 23 percent of these businesses have a robust, documented succession plan in place (PwC 2017); so whatever your specific solutions are, if you have "a robust, documented succession plan," you're already ahead of the curve!

Companies at early stages (Stages 1–2) need to develop emergency interim plans for each key risk position. If the person is unexpectedly unavailable to perform his or her duties, how will this job or function be performed in the near term? What impact could it have on business continuity?

In the later stages, companies need to focus on long-term systemic succession policies and plans that identify and develop potential succession candidates.

Ownership succession: The task of deciding who will take over as the equity holder is fraught with psychological and emotional issues. Succession touches on issues of control, power, and relevance that some may deem too sensitive to address. The circumstances that warrant ownership succession may also speak to the owners' retirement or the idea of their own mortality, which again may push them to delay engaging in the process.

Ownership succession planning is nevertheless critical for ensuring the long-term survival of the business—and the preservation of wealth that has been accumulated. Here are some questions business owner may want to consider:

▶ Have you defined your personal goals and a vision for the transfer of ownership of the company? (Ownership passing to the next generation? A management buyout? Private equity sale? Other?)

▶ Do you have an identified successor in place? Have your intentions been clearly communicated to the relevant parties?

▶ What implications does your plan have for the management of the company?

▶ Are there significant ownership or family issues that need to be addressed before ownership can be transferred?

It is essential to remember that ownership succession is not limited to the transfer of equity/value. Fundamentally, it is the transfer of *authority*—and ultimately, *legitimacy* to run the business. It will have direct ramifications for how the company is run; so it is crucial to make arrangements for effective shareholder decision making. For example, avoid an equal split of the shares among an even number of siblings, which may result in deadlocked shareholder meetings.

Management succession: Succession planning for the CEO and senior management is probably the most important issue that confronts companies. Yet many business owners do not carry out a managed transition to a successor leadership team. For example, in family-owned businesses, only 30 percent survive into the second generation, 12 percent survive into the third, and only about 3 percent operate into the fourth generation and beyond (Deloitte 2015). The following are some typical issues and mistakes that complicate management succession:

1. *Waiting too long to start the succession-planning process.* Founders often stay in active management as long as physically possible. That means that succession effectively becomes a near catastrophic event for the company. The founder/CEO dies or becomes ill, and the change of ownership and management happen simultaneously, creating various uncertainties and a power vacuum within the company. Even in the best-case scenario, the transition of authority happens so late that the founder cannot properly administer it or coach and guide the successor, leaving the successor to struggle to gain leadership legitimacy.

Founders (and later, boards) often don't assess the true management potential of their rising stars until it is too late. Homegrown candidates often can be the best options, if they've been identified early and developed to maximize their potential. Failure to do so often results in the most talented people leaving the company, especially family businesses, because they see no career prospects.

2. *Tendency for the current CEO (founder) to try to "clone" himself or herself—to find a new CEO with the exact same skill set.* This is particularly ill advised, because different talents are needed at different stages of company development.

3. *Micromanaging the successor.* Even when management succession has formally occurred, it can be stymied if effective authority is still wielded by an owner who is unable or unwilling to let go of control. Even the founders that officially moved to the board from management often find it irresistible to interfere in daily operations. They also may impose a specific management style, stifling the new CEO's creativity and proactivity.

This failure to transfer the authority severely hampers the ability of the new leadership, undermines its reputation in the company, and creates confusion among staff. (**See Box 3.3 on page 44 for some practical advice for entrepreneurs on how to let go of operational management.**)

4. *Failure to face family issues that directly affect the business.* This issue of management succession is even more important for family businesses, and it becomes particularly thorny as the family grows larger and several potential senior management candidates from different branches of the family become available.

Families in business might ignore the necessity of planning for the succession of their CEO for a multitude of reasons. Every family is unique and must find its own solutions, but here are some general pointers that may prove useful:

Box 3.3: The Art of Letting Go for Successful Entrepreneurs

Leslie Dashew is a family business adviser and co-author of *The Keys to Family Business Success*. In a conversation with Deloitte Tax LLP partner Tom Plaut, he shared his thoughts and recommendations for the best ways senior-generation family-business leaders can deal with the challenge of letting go.

"In my experience, somebody who has been a dynamic, engaged leader can't just let go and leave without having something to go to. And if they have had an active, engaged life, they can't just sit at home and read or watch television or play golf. In my experience they have to have something that's compelling that they go to. So the first piece is for leaders to begin to transition their energy long before they plan to let go of the authority. That may mean beginning to cultivate other interests. This is terribly difficult for entrepreneurs in particular, because they're typically consumed by their businesses.

"One of the most successful transitions I ever saw was a client who had started a construction business from scratch and built it to a value of $60 million. By the time he finally sold the business and transitioned it to new leadership, he had started helping a nonprofit build its new building. He was on its board, but he had that technical expertise and they really wanted that help. So he was able to take his knowledge, passion, and energy and place it somewhere else.

"The second piece is to have the confidence that the next generation will have the supervision—if you will, the oversight—to know they're doing the right thing. So one of the best possible strategies is to make sure that there is an independent board of directors who will provide the kind of oversight and guidance that the departing leader can trust.

"When that board is in place, and often the departing leader is on it for a period of time, then there's a sense that, 'Okay, I have my nose in and my fingers out, and I can keep an eye on what's going on.'"

Source: Deloitte (2015).

- Evidence indicates that family CEOs are more often focused on preserving the company's reputation and values. Professional managers are more likely to focus on sales growth.

- Overall, research shows that "internally grown" CEOs show better track records than the ones hired from outside the company. That said, if the company is in trouble or stagnating, the external hire might be a better way to go.

- For family management succession, it is increasingly common practice to require family members to gain relevant experience outside the company for several years. Often, they are allowed to come in only at the level they were able to achieve outside. This helps them build expertise as well as credibility within the company.

- There is a clear trend toward professionalizing management as the ownership moves to the next generation. More families realize that owning

a company and running it do not have to be the same thing. In this case, it is absolutely crucial to set up proper governance structures so the family can retain effective strategic oversight and control.

Specialized-expertise succession: Typically, this type of succession is much more straightforward than the ownership and management types. However, entrepreneurs need to be alert to one psychological factor: If you have specialists that qualify as key persons in high-risk positions, this gives those people a sense of security—and leverage. It is natural for them to want to remain indispensable. Therefore, it is important that the terms of references for those positions state clearly that preparing a potential successor (emergency and long-term) is a key deliverable they will be evaluated on. It is also important to test the readiness of the successor—for example, by requiring the key-risk person to take a long vacation or take on another, temporary assignment, thus giving the successor an opportunity to be tested.

Human Resources Planning

Human resources is a vast topic that goes beyond the scope of this Guidebook. We will touch only on the broad outline of policies related to the top managerial and technical talent.

We came across the following analogy, sometimes used in the private equity world: people can be considered the "software" that runs the business, as opposed to "hardware"—physical assets. Hardware is rapidly becoming a commodity—easy to buy or copy. A true differentiation—true value-added that is much harder to obtain—comes from software.

For example, the U.S. airline industry "has reported negative net income in 23 of 31 years since deregulation" in 1978 (Phillips 2011). By contrast, during roughly the same period, Southwest Airlines started as a midsize company with just three airplanes and turned into the country's biggest carrier. It "remained solvent and has consecutively generated a profit for the past 39 years" (Schlanger

2012). Southwest flies the same airplanes as everybody else; but from the very start of the company, it heavily screened potential employees and created a distinct working culture that proved impossible for competitors to recreate (Romero 2008).

Human resource planning typically comes into focus in Stage 2. Companies report challenges in attracting qualified staff, having the capacity to afford high salaries, and motivating and retaining staff—especially with the higher expectations of the younger generation.

Psychologist Frederick Herzberg introduced a very practical framework, known as "two factor theory" to address these challenges (Herzberg 1968). Companies should focus on two distinct objectives: *minimizing staff dissatisfaction* and *maximizing motivation*.

Minimizing demotivating factors: Herzberg introduced the concept of "hygiene factors," which include status, job security, salary and benefits, quality of supervision, and other work conditions. Research shows that addressing these factors does not lead to employees being positively satisfied with the job or more motivated to perform. However, if these factors are *not addressed* properly, employees will become actively *dissatisfied*. These are "maintenance factors," in the sense that staff dissatisfaction results from their absence.

Eliminating the reasons for job dissatisfaction is the first step in building a productive workforce. There's no point trying to motivate people until these issues are out of the way! If your company experiences high employee turnover or a large number of staff complaints—even if people find the work itself interesting—it might be an indication that "hygiene" work conditions are not up to par.

Hygiene factors, such as supervisory practices or wages/benefits, are highly culture- and industry-specific. Here are some general pointers for addressing them:

▶ Foster teamwork and respectful working relationships.

▶ Identify and address poor and obstructive company policies that act as "irritants" to staff or that go against company culture.

▶ Provide supportive and nonintrusive supervision.

▶ Be sure your benefits package is competitive; identify benefits most valued by employees.

▶ Provide for job security.

⚙ **TIP: The most important step is to give your employees a voice in establishing the company's culture, work environment, and policies.**

Maximizing motivating factors: A 2015 Gallup survey found that only 32 percent of U.S. workers were "engaged" in their jobs, while 51 percent were "not engaged" and 17 percent were "actively disengaged" (Adkins 2016). If your staff do not leave or complain much, yet also don't seem to be particularly interested in work (working for the paycheck), it might signal that the hygiene factors have been addressed, but now you need to move to the next step—to actively motivate your staff for maximum performance.

Business writer Daniel Pink summarized the diverse research on employee motivation into three practical categories: mastery, autonomy, and purpose (Popova 2013).

Job mastery, as a motivation, is the desire to gain better skills and knowledge. A business can take several actions to support it, including the following:

▶ Training, coaching, and delegation of important tasks for professional advancement and excellence. Learning and development are especially valued by the younger generations entering the workforce.

▶ Job enrichment through adding more important and interesting tasks.

▶ Recognition and rewards for good performance and contribution.

Autonomy means that employees have meaningful control over various aspects of their work, which promotes their sense of ownership and responsibility. Learning to delegate is a crucial skill for the entrepreneur who wants to create a sense of autonomy in the employees.

Purpose is the desire to do something meaningful and worthwhile. It should be integrated with the company's values and business objectives. Entrepreneurs rarely start businesses to simply get rich. They have visions, dreams, and ideas, and they should not shy away from sharing those with employees. When Herb Kelleher set out to create Southwest Airlines, he explicitly hired people to provide superior customer service with "a sense of warmth, friendliness, individual pride"—and motivated them to do so.

All three categories aim to build intrinsic, internal motivation to perform better. Decades of research shows that intrinsically motivated people consistently outperform those motivated by money or other external benefits (Chamorro-Premuzic 2013).

Monetary rewards and recognition: Focusing on intrinsic motivation does not mean that you can ignore financial incentives. There is a strong practical argument for giving your key staff some "skin in the game" to build a sense of ownership and to reward good performance.

Key performance indicators can be an effective motivation tool for key management and technical staff, starting in simple form with Stage 2. KPIs for managers can be established with three main components:

▶ Individual—to assess the behavior of the manager in areas such as teamwork, leadership, ability and eagerness to learn, and so on.

▶ Functional—to assess how the manager's function or unit has performed relative to the objectives.

▶ Enterprise—based on the performance of the company as a whole, to encourage managers to work as a team.

These KPIs should form the basis for pay raises, bonuses, and other recognition, including nonfinancial. KPIs are also an important communication tool to signal the company's culture and priorities.

A *profit-sharing plan* can be devised for key management team members and other staff seen as essential to the company's success. (Some companies do this for all staff.) For example, on target fulfillment, a company will distribute 10 percent of the profits to stakeholders in the plan.

An *employee stock ownership plan* makes company shares part of remuneration to promote long-term commitment. This incentive allows companies to make the overall benefit package more competitive, and it makes key employees less vulnerable to poaching by other companies. It is also sometimes used by family businesses to encourage essential staff to stay during the transition of ownership and management from one generation to another.

Balancing intrinsic motivation and monetary rewards:
There is a growing body of evidence that variable pay—"pay for performance"—should be used carefully. Contingent pay only works for routine tasks. However, for people working on creative tasks—where innovative, nonstandard solutions are needed—results showed that, in a large percentage of cases, variable pay hurts performance. Managers may "cook the books," focus on short-term results, or emphasize "measurable" factors, such as sales, over important but hard-to-measure ones, such as company culture or the quality of customer service.

This reinforces the need to focus on building intrinsic, internal motivation, as discussed above. Be sure your managers' fixed salary is high enough that they don't have to "think about money" and can focus on the work itself instead. The variable component should function as a reward and recognition and not be the *main* motivator or source of income.

Determining the optimal mix of variable and fixed pay is one of the key strategic HR functions that should be fully established by Stage 3.

TIP: SMEs often cannot compete with larger companies on pay levels, but they have more flexibility to address their employees' needs for *mastery*, *autonomy*, and *purpose*.

B **LP**

Leading Practices:
Decision Making and Strategic Oversight

Below, we present leading common practices for each SME evolutionary stage, using the categories discussed above:

▶ **Management Decision Making**

▶ **Advisers/Advisory Board**

▶ **Board of Directors**

▶ **Succession Planning**

▶ **Human Resource Planning**

Note that these practices are cumulative: practices for later stages build on the practices of earlier stages. Some recommendations may be implemented more effectively in different stages, depending on circumstances, or may be implemented as the company is transitioning from one stage to the next. Use your judgment to decide the best timing for your particular company.

Stage 1: START UP BUSINESS

Management Decision Making

Conduct individual consultations with key executives before making major decisions.

Define and communicate authority limits for key personnel, such as amounts of purchases that would require CEO authorization. A core element of internal controls (***see page*** 53) is *clearly defined authority limits* to ensure that key staff members remain engaged and motivated to act in the company's best interest. These parameters facilitate increased accountability and reduce the unnecessary dependence on owners for day-to-day decision making.

Advisers/Advisory Board

Involve external trusted advisers (even if informally) to discuss strategic issues.

Management Decision Making

Develop an authority matrix that defines key decisions and identifies which business units or individuals are authorized to make them. This should include decisions for the founder/ shareholders, board (if one exists), CEO, key executives, and technical specialists. List key decisions and decision makers and, after discussion and consultation where needed, identify the people who are to be responsible, accountable, consulted, or informed for each decision. All involved have to be committed to standing by the agreed authorizations—not doing so can erode employee trust, confidence, and commitment.

Management should meet regularly as a group to collaboratively review operational issues and progress against plans, and to identify risks/issues and take decisions. The group is engaged by the CEO/owners for consultations on strategic issues, as needed.

Advisers/Advisory Board

Articulate areas/topics of needed external expertise (providing input on company strategy, financing plans, new markets and products, technical issues, company structure, business relationships, external company profile, coaching of executives, or other). Focusing first on areas of need drives owners to extend their search beyond the "usual suspects," which leads to a more customized and valuable pool of expertise.

Define the role and formalize the involvement of the needed external advisers. Make sure the advisers understand their role and are engaged effectively to add value to the company.

Succession Planning

Create a contingency/business-continuity plan for the CEO and other key persons. It should describe a course of immediate action in case of sudden departure or unavailability.

Human Resource Planning

Develop a simple means of communicating to staff the key decisions, policies, and strategies.

Document HR-function job descriptions to ensure that all key roles are being addressed (or outsourced).

Develop internal (or outsource) expertise on management reporting and analytics—to help with cost control and strategic decision making. Accurate and timely data are important for effective decision making.

Management Decision Making

At this point, a formal executive committee (the CEO and key senior-level executives) should be established; it 1) meets weekly/biweekly on operational issues and 2) has dedicated sessions to focus exclusively on strategic issues, with a set agenda. Ensure that the committee has clear terms of reference.

At executive committee meetings (for example, monthly or quarterly), review progress against the plans, and update plans as necessary.

Advisers/Advisory Board

Consider whether setting up a formal advisory board would add value to the company. If so, formalize the arrangement and communicate it to all relevant stakeholders.

Succession Planning

Develop a basic succession-planning framework for senior management, to ensure timely preparation of a talent pool. Owners want to be confident that, when needed, people are ready and willing to fill the critical roles outlined in the succession plan that will carry the organization forward. The three key steps toward building a viable talent pool are 1) determine the leadership demand, 2) evaluate the current talent supply, and 3) mobilize and develop potential leaders.

Human Resource Planning

Make the HR function a strategic partner with (and/or part of) the strategic management team (for example, helping design effective sourcing and retention strategies, compensation and benefits programs, professional development programs, and performance management systems).

Expand the job description for each position to form detailed terms of reference that include the qualities and qualifications required. Review the qualities and qualifications of current staff to see whether they fit the TORs.

Design an incentives system to attract high-caliber talent and motivate them to perform (mastery, autonomy, purpose), including clear professional and career-growth opportunities and performance-based recognition and incentives (bonuses, stock options, profit sharing, and so on).

Take care of *hygiene* factors to retain staff, such as attractive work environment, internal company policies, competitive compensation and benefit package.

Board of Directors

Clearly define the role of the board, especially its relationship to management, and include directors' duties and responsibilities to the company and shareholders in the board charter and the director appointment letter.

Determine the skills required for the board to fulfill its duties, given the strategic direction of the company; evaluate the existing board skills and note any gaps.

Ensure that the board has an appropriate mix of directors, considering skill sets, professional background, personal attributes, diversity (age, gender, and so on), and balance of executive, non-executive, and independent directors.

Create effective and efficient board procedures:

▶ Allow enough time for effective discussion and input from all directors.

▶ Provide a focused agenda for each meeting, based on the annual board calendar.

▶ Maintain a balance between management presentations and board discussions, and between reviewing past performance and strategic planning.

▶ Distribute action-orientated and concise board briefing papers at least five business days before board meetings.

▶ Take and approve minutes (discussions, opinions, and decisions). Use them to ensure diligent follow-up.

Succession Planning

Develop strategic succession plans for the CEO, key executives, and technical specialists (to include immediate, mid-term, and long-term succession).

Leading Practices: Decision Making and Strategic Oversight

LP

B

3

C

Risk Governance and Internal Controls

"Controls protect weak people from temptation, strong people from opportunity and innocent people from suspicion."

—Internal Auditor Magazine, 1977

Stage 1 START-UP BUSINESS	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
▶ Basic bookkeeping, cash flow management, and tax functions ▶ Cash sources, bank accounts are separate from those of the founder(s) ▶ Basic understanding of regulatory requirements and compliance	▶ Basic principles of business conduct ▶ Basic business risks—including key-person risks—identified ▶ Processes in place for tax payments, records, and filing ▶ Controls on cash management	▶ Detailed code of ethics and business conduct ▶ Objectives, strategic planning, budget, KPIs, and clear accountabilities ▶ A professional CFO ▶ A basic internal audit function ▶ Policies and procedures to monitor and mitigate strategic and operational risks ▶ Business units have clear authority, reporting lines, and guidelines	▶ Effective internal controls systems (e.g., based on COSO) ▶ Independent external auditors ▶ Timely and secure recording and reporting for sales and accounts

We separate the challenging topic of *Risk Governance and Internal Controls* into common topics that most entrepreneurs are familiar with, at least in general terms:

▶ **Internal Controls**

▶ **Audit (internal and external)**

In the most basic sense, *internal controls* can be defined as policies and practices to allow SMEs to detect errors, prevent mistakes, identify fraud, and ensure the reliability of financial reports. This is the minimum that internal controls must accomplish at Stages 1–2.

However, understanding of internal controls has evolved significantly in recent years. Their role expanded to

managing key risks to company success. The Committee of Sponsoring Organizations (COSO)—the world's leading organization focusing on developing common standards on enterprise risk management, internal controls, and fraud deterrence—defines internal controls as "A process… designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance" (COSO 2013). Although the COSO standards might prove too complex for many SMEs, setting up a more strategy-oriented system of controls is key for a company's success. This shift in focus is crucial starting with transition to Stage 3, when the company starts putting more effort into strategic planning.

Internal audit is a function designed to provide management (and later the board) with reasonable assurance that

the internal controls are adequate and functioning well. The function appears in Stage 3, to support increased decentralization of decision-making authority.

External audit is an independent examination of the financial statements prepared by the organization. Unless mandated by law, this is a function not typically needed until SMEs acquire external shareholders, in Stage 4.

Internal Controls

Internal controls, as the name suggests, focus on the risks to the company's operating, reporting, and compliance objectives that can be addressed by better *internal* processes, policies, and procedures. Such risks include, for example, fraud, damage to company property, cost overruns, substandard quality of products, or mistakes in financial reporting.

Implementation of the internal controls function is the responsibly of management, with guidance and oversight from the board of directors (when formed).

Elements of Internal Controls

An internal controls system helps the SME answer these five critical questions:

▶ What is our overall approach to internal controls?

▶ How do we identify and monitor risks?

▶ What do we do to minimize these risks?

▶ How do we get, analyze, and share risk-related information?

▶ How do we make sure that all systems work effectively and as planned?

The internal controls system therefore consists of five elements: control environment, risk assessment, control activities, information and communication, and monitoring. (**See Figure 3.1.**) These elements work continuously as an integrated system.

1. ***Control Environment***—the set of standards, processes, and structures that provide the basis for carrying

Figure 3.1: Internal Controls Elements
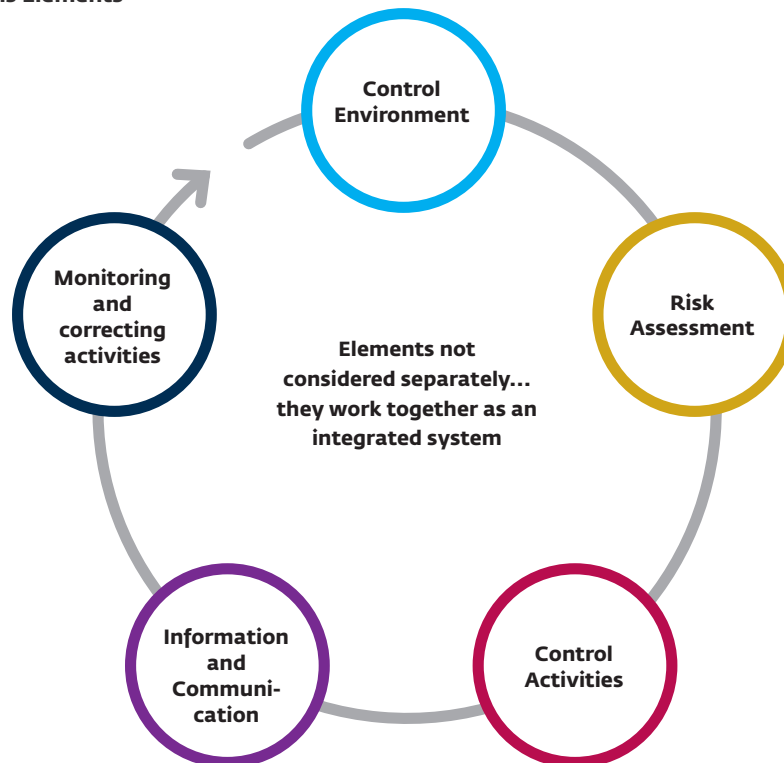
out internal controls across the organization. The control environment sets the tone of the organization, influencing the control consciousness of all its employees; one example is the often overlooked code of ethics/conduct. It also includes *soft* elements, such as management's philosophy and operating style and the way management assigns authority and responsibility.

The tone at the top is crucially important and will override other elements if in conflict. For example, if the leadership emphasizes achieving targets at all costs, the staff might feel encouraged to bend some rules to do so.

Another crucial element of the control environment is the company's strategy and objectives. Often, even the top executives of SMEs do not have a good understanding of where the company is going. The situation is even worse down the chain of command. If employees do not understand the company objectives, it will be very difficult for them to assess risks jeopardizing the company's progress toward those objectives.

2. **Risk Assessment**—involves an established formal process for identifying and assessing risks in relation to the achievement of objectives. Discussion of potential risks can be uncomfortable for some people, making them reluctant to volunteer their thoughts and concerns—especially if, for example, the founder/CEO presents a new idea he or she is clearly excited about. Therefore, specialists on risk management recommend that every strategic decision include a dedicated discussion on risks. The "boss" should explicitly call for this analysis. Furthermore, an enterprise should have a dedicated risk management meeting at least once a year.

Successful entrepreneurs perform this analysis routinely, but the focus is often on external risks, such as competition and regulations, while internal risks are overlooked.

Tip: SMEs interested in becoming part of the supply chain of larger corporations, especially multinationals, need to proactively address environmental and social sustainability risks. For example, agro-commodity companies require their suppliers to address issues related to forced or child labor, work safety, and significant impacts on biodiversity and the ecosystem (IFC 2013).

3. **Control Activities**—are actions, established through policies and procedures, to detect and prevent risks and help ensure that management's directives to mitigate risks are effectively carried out. (**See Box 3.4 for some examples.**)

4. **Information and Communication**—ensure that management obtains relevant, timely, and quality information (from internal and external sources) to support the functioning of other components of internal controls. Communication is the continual, formal process of providing, sharing, and obtaining necessary information.

A typical problem in many SMEs is that the various IT systems do not "talk" to each other and require manual reconciliation, which happens episodically and carries the risk of human error.

5. **Monitoring Activities**—are ongoing evaluations to ascertain whether each of the five components of internal controls is adequate and functioning. Reconciliation of accounts is one example.

Box 3.4: Control Activities Examples

Authorization

▶ Clear authorities and their limits for review and approval of various transactions

▶ Defined lines of responsibility

Performance reviews

▶ Regular checks, review of personnel

▶ Ensuring employee knowledge and skills

Information processing

▶ Accurate records of key transactions, including approving parties

▶ Automated controls limiting inputs into the system, checking dates

▶ Sequential numbering of documents

▶ Batch totaling or reconciliation total added and cross-checked

Physical controls

▶ Limited access to equipment, petty cash

▶ Cameras

Segregation of duties (each participant's actions are controlled and/or verified by another participant)

▶ Authorization activities from related recordkeeping (sales, payroll, purchasing, etc.)

▶ Custody activities from related recordkeeping and reconciling activities

▶ Depositing cash from reconciling bank accounts

▶ Systems development from systems operations and from database administration

Crisis Management Plans:

▶ Roles and responsibilities for organizing during crises

▶ Scenarios for responding and recovering from potential crises

Case Study: Rockstar Internal Controls

Rami Bahgat aims to have about 100 outlets across Egypt in five years. Here is a quick illustration—focusing on just one specific risk—of how the systematic approach to internal controls might help him achieve this objective.

None of the Rockstar managers is currently aware of Rami's vision. So *Step 1: Control Environment* would require involving the key managers in designing a strategy for this vision, and empowering them to meet regularly as a group to analyze the progress and risks.

Step 2: Risk Assessment would quickly bring to the surface the cash flow issue. The chief accountant has already complained privately, "Our main challenge is cash flow shortages and defaults in paying due checks, resulting from high inventory that has up to seven months' worth of stock."

Therefore, *Step 3: Control Activities* would have to minimize overproduction. The company orders the manufacture of too many models that are selling slowly—and possibly orders too few models that are selling well. There is no IT system to generate timely information on the sales by wholesalers and Rockstar's own stores—and to compare them with the existing orders and the remaining inventory. There are separate applications that track different components of the manufacturing-sales process, and the interface between them is done manually and sporadically.

Implementation of the comprehensive IT system as a *control activity* to regularly track sales and inventory would allow the company to free up cash currently "stuck" in its warehouses, and increase sales by being more responsive to client demands.

Such an IT system would also be an important element of both *Step 4: Information and Communication* and *Step 5: Monitoring Activities*. It would be supported by other related activities, such as, for example, physical inventory monitoring.

TIP: Establish an effective channel for reporting fraud and abuse. The Association of Certified Fraud Examiners (ACFE) discovered that "tips are consistently and by far the most common detection method." ACFE analysis shows that organizations with hotlines are much more likely to catch fraud and experience "frauds that were 41 percent less costly, and they detected frauds 50 percent more quickly" (ACFE 2014).

Special Issues

The types of risk that SMEs will need to address will differ widely by industry and other factors, but two that are common to virtually all businesses—*working capital and cash flow management* and *information technology*—can be particularly destructive to smaller companies.

Working capital and cash flow management. For a company, *working capital* is defined as the difference between current assets and current liabilities. Current

assets are elements such as bank accounts and bank placements, securities, inventories, and receivables that can be turned into available cash within 12 months. Current liabilities are the costs and expenses—such as paying suppliers, rent, utilities, and interests—to be incurred within the same period, namely 12 months.

If current assets are higher than current liabilities, then the working capital is positive and the company can easily fulfill its current financial obligations. Because small companies may not have easy access to short-term credit options, maintaining a positive working capital balance is key. If the owner intends to grow the business quickly, the need for positive working capital is higher than for a business owner looking to stay small.

Internal controls can help the owner better manage the ebb and flow of money coming in and moving out—and improve visibility, predictability, and planning. Internal controls can also help address inefficiencies, thus increasing the short-term financial management of the company.

Cash flow is the net amount of cash moving into and out of a company. For the company to be financially sustainable, its business must generate a positive cash flow, namely more money coming in than being spent. How a company manages cash flow depends on multiple factors—for example, industry, operational efficiency, and ultimately a good strategy. Internal controls can help a company have a better understanding of and more control over the different processes, hence strengthening the ability to correct potential inefficiencies and to improve both the working capital and the cash flow management of the company.

Information technology. To thoroughly cover this topic would take an entire book; this Guidebook touches on the basic need for businesses to be aware of the benefits of IT and to be alert to its challenges.

As a bare minimum, owners need to ensure that both hardware and software are updated to stay current with the needs of the business, that they perform efficiently, and that the IT equipment and software do not fail or fall prey to external attacks. As the company handles third-party data, such as customer information, there is a need to ensure compliance with applicable laws related to data protection, and to install protective mechanisms to prevent loss, breach, or unlawful theft of confidential or business-sensitive information—occurrences that could cause the company to face lawsuits and loss of reputation and business.

Conduct/Ethics

Although the topic of *conduct and ethics* is not a separate element of **Internal Controls,** it deserves its own discussion, as it directly affects every one of those elements. All companies have ethics—the values that are lived in the company and the principles that govern how decisions are made. A company's ethics create its organizational climate and inform its culture.

To provide direction to employees and establish an image of good behavior, companies establish codes of ethics and conduct. The terms "code of ethics" and "code of conduct" are often used interchangeably (Nieweler 2014). They are, in fact, two distinct documents:

▶ The code of ethics sets the tone by explaining key organizational values and ethical principles. It specifies commitments or ethical standards that the company adopts in relation to its stakeholder groups (employees, customers, business partners, government and community, society, environment, and so on).

▶ The code of conduct is the translation of the proclaimed values into actionable practices. It establishes a framework for professional behavior and responsibilities, dealing with ethical issues and conflict situations. It lists actions that are required or forbidden.

SMEs can combine the two documents into a single code of conduct/ethics. It should be approved by senior management and the board of directors, and it is their responsibility to ensure proper compliance with the code. Compliance should be monitored and enforced. Businesses experiencing rapid growth should review the code regularly to ensure that it remains relevant and effective. (**See Box 3.5. on the next page.**)

Box 3.5: Control versus Trust Continuum

Sound governance aims to lead executives and employees to comply with the rules, behave ethically, and make decisions in the best long-term interests of the organization. There are two approaches to achieve this goal: one is centered around controls; the other, on trust. Academics, regulators, and executives have traditionally prioritized the control-based approach. It is based on the premise that people think only of themselves. As a result, this view emphasizes the need for organizations to implement a full set of "carrots" and "sticks" in order to align interests and induce desired behaviors.

This perspective has some merits, and controls related to the identification and monitoring of key business risks are particularly relevant for most organizations. On the other hand, the emphasis on controls should not be seen as a panacea. Despite the millions of dollars spent every year on control and compliance programs, frequent corporate scandals suggest that they have not succeed in significantly reducing the level of unethical (or even illegal) conduct in the business world. It is also important to note that most companies involved in these high-profile cases, such as Wells Fargo, HSBC, VW, and Petrobras, used to have control functions in place as well as many internal policies aligned with recommended practices.

The other alternative is investing in the trust-based approach. It operates on the premise that most people will voluntarily seek to do the right thing when they are immersed in a culture characterized by solid shared values, transparency, psychological safety, justice, empathy, responsibility, and sense of purpose beyond profits.

The concept of psychological safety is critical. When an atmosphere of fear is created inside organizations, people tend to become defensive and afraid to express their points of view, including on ethical issues. To reduce fear, it is essential to foster an environment where people feel that they will not suffer negative consequences—such as retaliation, ostracism, or dismissal—if they speak up and point out what is wrong. Research also shows that working in such environments generates a higher level of productivity and innovation (Baer and Frese 2003).

Strong ethical culture allows entrepreneurs to build what Legal Research Network (LRN), a firm devoted to these issues, calls "self-governing organizations": companies in which the regulation of behaviors does not depend on rules and policies, but instead on workplace peers. In one of its studies, LRN observed that companies characterized as self-governed exhibited significantly better performance indicators than the others in several areas, including profitability, revenue growth, and innovation (LRN 2016).

An increasing number of companies—such as Patagonia, Southwest Airlines, FAVI, Buurtzorg, Morning Star, and others—are excellent examples that it is possible to succeed by focusing on an ethical culture based on trust (Laloux 2014). Studying these cases in depth can help entrepreneurs create concrete practices that lead to a high-trust environment at their firms.

Business leaders also need to start measuring and monitoring the degree of ethical culture in their companies. Ethical Systems, for example, provides a free tool for this (Ethical Systems 2018).

Instead of being dichotomous options, the control and trust approaches to governance must be seen as a sort of "continuum." It is up to leaders to increasingly move their companies to the trust side of this continuum to bring out the best in their people.

Source: Alexandre Di Miceli da Silveira.

SMEs should develop an explicit policy to guide directors, management, and staff on the issue of conflict of interests. This policy should spell out what constitutes conflicts of interest and outline how the organization will monitor and resolve them. It should also identify potentially high-risk functions.

The policy should pay particular attention to procurement. Staff involved in the procurement process should declare if they have a beneficial interest, relatives, or close friends in any entity being considered for selection as a supplier of goods or services to the company.

Conflicts of interest: In certain situations, key business representatives may experience a potential conflict between their own personal interest and their duty to the company. A conflict of interest is a situation in which a person has a private or personal interest potentially sufficient to influence—or *appear* to influence—the objective exercise of his or her official duties as an employee or a professional. (**See Figure 3.2.**)

Related-party transactions (RPTs) are conflict-of-interest situations that deserve special attention. RPTs are business deals or arrangements between two parties that are joined by a special relationship prior to the deal.

Figure 3.2: Conflict of Interests: Most Common Forms

Related-party transactions	**A person who controls all or part of an organization causes it to enter into a transaction—with a professional or another organization—that will benefit that person or that person's family or friends.**
Outside employment	**The interests of one job are in conflict with another.**
Family interests	**A spouse, child, or other close relative is employed (or applies for employment), or the company purchases goods or services from such a relative or a firm controlled by a relative.**
Gifts	**Items from friends who also do business with the person receiving the gifts, which may include intangible things of value, such as transportation and lodging.**

For many small businesses, RPTs are not unusual; transactions with businesses of family members, relatives of directors, substantial shareholders, and key employees are a common occurrence. Under some circumstances such transactions can be beneficial for the business. Unfortunately, they are also one of the main ways to siphon money from the company to enrich individual shareholders or managers at the expense of others. This could scare away external investors as well as demotivate honest employees.

Each company has to develop an explicit policy for dealing with related-party transactions, taking into consideration their size, type, frequency, and the parties involved. For example, the policy needs to specify the size of the deals that would require approval by the board and/or the shareholder meeting.

On such transactions, full disclosure to all shareholders is crucial. SMEs should identify the number and size of those transactions as well as the policy or procedure governing the transactions. (**For more information, see *Governance Topic D. Disclosure and Transparency*, beginning on page 65.**)

Audit

Entrepreneurs often mix up *internal controls* and *internal audit*. Internal controls is a *system*, operating continuously. Internal audit is a *function* of internal controls, conducted at specific intervals. Internal audit aims to provide the board and management with reasonable assurance that the internal controls system (among others) is adequate, robust, and functioning well.

As part of good governance, a Stage 3 SME should have in place an internal audit function. To be effective, the internal audit function should be independent of operations. By Stage 4, it should report functionally to the board, with administrative reporting to the CEO.

Depending on the legal structure and the applicable laws in the country of incorporation, a company might need to hire an *external auditor*. If there is no particular legal requirement to do otherwise, this function becomes relevant in transitioning to Stage 4. The external auditor directly serves the interests of shareholders/stakeholders by independently ensuring that the company is practicing sound fiduciary control and reporting accurately, fairly, and transparently on its financial accounts.

Best practice for managing external auditors includes the following actions:

▶ Restrict the auditor from providing other services that may cause conflicts of interest.

▶ Consider rotation of auditor—or at least senior audit partner—every five years.

▶ Disclose fees paid to the auditor for audit, and if the company still choses to obtain non-audit services, disclose the amount paid for those as well.

Internal and external audits serve different functions. Internal auditors examine issues related to company business practices and risks, and internal audits are conducted throughout the year. External auditors examine the financial records and conduct a single annual audit. Starting with Stage 4, the company needs to have both.

Leading Practices:
Risk Governance and Internal Controls

Below, we present leading common practices for each SME evolutionary stage, using the categories discussed above:

▶ **Internal Controls, with three topics requiring special attention:**

– Conduct/ethics

– Working capital and cash flow management

– Information technology management

▶ **Internal Audit**

▶ **External Audit**

Note that these practices are cumulative: practices for later stages build on the practices of earlier stages. Some recommendations may be implemented more effectively in different stages, depending on the circumstances, or may be implemented as the company is transitioning from one stage to the next. Use your judgment to determine the best timing for your company.

Stage 1: START UP BUSINESS

Internal Controls

Ensure that the company complies with main laws and regulations.

Working capital and cash flow management:

▶ Separate the cash sources and bank accounts of the company from the personal sources and accounts of the founders.

▶ Routinely monitor and analyze cash flow needs to effectively plan working capital and financing needs and investment strategies.

Conduct a basic valuation exercise to understand a total net worth of the enterprise. It's generally accepted that there are three basic ways to describe the value of a business: fair market value,

investment value, and liquidation value. Having an objective appreciation for the investment value of the business is an important bargaining tool when approaching potential investors. This is the value the business represents to a specific investor and incorporates specific considerations above and beyond the fair market value.

Stage 2: ACTIVE GROWTH

Internal Controls

Create a mechanism for reporting fraud and abuses (for example, a whistleblower policy). Such a policy should provide guidance for staff to confidentially report their concerns, and it should outline appropriate steps to investigate and address violations (disciplinary or otherwise).

Identify potential business risks, assess their impact, and develop corresponding mitigation actions (with owners to track progress).

Integrate basic risk-based controls into the business processes (such as approval limits, separation of authority, verifications, and so on).

Identify critical key-person risk positions, designate backup/deputy staff for key functions/ technical specialists, and ensure that they are building needed skills and expertise.

Ethics/conduct:
▶ Develop basic principles of business conduct, covering such issues as workplace ethics, what constitutes theft and fraud, actions in cases of conflicts of interests, and so on.
▶ Communicate these principles and penalties to staff.

Working capital and cash flow management:
▶ Define signatory authority over bank accounts and control over cash management, with thresholds, delegation, and segregation of duties.
▶ Ensure that sound bookkeeping is in place, with all investments and loans/credits recorded.
▶ Make cash flow reports and forecasts part of planning discussions to determine future financing needs and drive investment decisions. Ensure that any investments take into account cash flow needs (riskiness, terms, maturities, liquidity).

Information technology management:
▶ Document clear TORs for the IT function, to ensure that all key IT needs are being addressed to support further growth of the company.
▶ Consider which IT functions should be in-house versus outsourced.

Make sure the IT system that is used to generate data and reports is secure; develop formal safeguard processes for administering security and *business continuity/disaster recovery*.

Internal Controls

Create policies and procedures to monitor and mitigate strategic and operational risks in accordance with the business vision and plans. The executive committee should have the key role.

Define authority and limits of business units, their reporting lines, and guidelines on key processes, to create a path of accountability for every project and activity.

Ethics/conduct:

▶ Develop a detailed code of ethics and business conduct, use it in the induction process, and reinforce it regularly in communication with staff.

▶ Establish appropriate remedial actions to violations of the code of conduct, and communicate throughout the organization the results/consequences of noncompliance. Ensure that penalties for breaches are clear and effective.

Working capital and cash flow management:

▶ Hire a professional CFO (if there are external investors, do so in consultation with them).

Information technology management:

▶ Develop a simple IT strategy to anticipate future business needs (functionality needs, infrastructure needs), and prioritize system initiatives over the short and medium terms to better plan capital requirements.

▶ Conduct an independent IT audit to make sure the systems are secure and can support the organization's goals and objectives.

Internal Audit

Establish an independent and effective internal audit function, coordinating with compliance and risk functions. It can be in-house, outsourced, or co-sourced (using an external firm to work with internal staff to train and bolster expertise). The owners should ensure maximum possible independence of internal audit to assure full transparency of risks/problems that need to be addressed.

Ensure that internal audit is looking at high-risk areas of the business to give added assurance—and consider ex post or less intensive monitoring for low-risk areas, to make the best use of time/resources.

Internal Controls

Ensure that management (executive committee) regularly reviews progress against the business plan and identifies and addresses risks with appropriate internal controls.

The board should regularly ensure that the company has a sound system of internal controls.

Information technology management:
▶ Establish IT systems to record and display sales and accounts, and accurately estimate accruals and revenue at any given time.
▶ The system should be robust, to protect against unauthorized use and to flag potentially problematic transactions.

Internal Audit

Have internal audit report functionally to the board of directors, or a committee of the board of directors (typically the audit committee), and not to the CEO except for administrative purposes. Ensure that audit plans are approved by the board.

Ensure that the internal audit coordinates with the external auditor.

External Audit

Appoint a recognized external auditor. Make sure the external auditor reviews and reports on significant controls deficiencies.

Ensure independence of the external auditor by restricting it from providing other services that may cause conflicts of interest (for example, consulting, tax services).

Consider rotation of auditor, or at least senior audit partner, on a periodic basis (such as every three years).

D

Disclosure and Transparency

"Disclosure and transparency are the partners of good governance; they demonstrate the quality and reliability of information—financial and non-financial, provided by management to lenders, shareholders, and the public."

— Saleem et al. 2008

Stage 1 START-UP BUSINESS	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
▶ Basic financial accounts prepared ▶ The same financial information and data are used for all purposes	▶ Monthly bank account reconciliation disclosed to all founders ▶ Founder(s), shareholders, and directors periodically receive consistent financial and nonfinancial information ▶ The public profile of the enterprise has been developed	▶ Financial statements in accordance with national accounting standards ▶ Point person for information sharing identified ▶ Key decisions are formally communicated to all staff ▶ Basic performance reports are presented to external advisers ▶ Key nonfinancial information is disclosed to the public	▶ Financial reporting is in accordance with the IFRS for SMEs or U.S. GAAP (if having/ seeking foreign investors) ▶ Financial statements are audited by a recognized auditing firm ▶ Quarterly financial reports and comprehensive performance reports are provided to investors ▶ An annual report (or equivalent) is produced. Shareholders are provided with information on request

This section covers the basics of disclosure:

▶ *Financial Disclosure*—the disclosure of financial and operating results.

▶ *Nonfinancial Disclosure*—the disclosure of nonfinancial company information, including past performance and potential opportunities and information on the company's governance practices.

The need and benefits of transparency and disclosure shift along with changing shareholder composition. In the early stages, the shareholders are typically few and heavily involved in running the business. The team is small, so the key internal stakeholders are well informed about material developments. Therefore, focus at this stage is on preparing accurate and timely financial information to all shareholders. At the later stages new non-managing shareholders may appear, old shareholders may no longer be directly involved in operations, and the business itself becomes larger and more complicated. The importance of nonfinancial information increases, and its target audience becomes more diverse—external advisers, directors, company staff, shareholders, and clients can be some of the key groups that the company may need to keep informed.

General Guidelines

The terms *transparency* and *disclosure* are often used interchangeably. They are indeed complementary and overlapping, but there is an important distinction to highlight. Disclosure is a legal obligation to provide certain types of information and content to certain parties. Transparency is the emanation of a corporate culture of openness—and one of the best ways to showcase that culture to the outside world.

A company's practice of disclosure and transparency increases investors' trust and therefore improves the company's access to external capital and lowers its cost. It also gives the company an opportunity for early identification of risks and weak points, which lowers the overall risk of company crises and scandals, and improves operational performance.

SMEs are often concerned about disclosing information, for fear that competitors can gain sensitive information on their business and financial condition. In reality, though, sensitive business information is surprisingly limited and is more likely to involve corporate strategy, products in research and development, pricing terms, and so on. As an owner, you need to remember that the market already knows you and your product/service, because customers know you, and your competitors know you, just as you know your competitors. Therefore, providing information is not about revealing your secret formula, rather it is about taking the opportunity to share who you are from your own perspective.

Also, most competitive companies gain their advantage and barriers to entry from doing something that cannot be easily replicated, as Southwest airlines did. For those companies, the advantage is in their way of doing things; therefore, disclosure of business data will not allow a competitor to simply copy the process.

Business owners should develop policies defining what constitutes confidential information (including for whom confidential material is reserved) and what information can be provided to stakeholders beyond required disclosure obligations. This should be a simple one-page document with examples and a contact person who can clarify the status of information if it is unclear.

Financial Disclosure

Financial statements provide information for making economic decisions. They cover the financial position, performance, and relevant changes in the financial position of the business. For SMEs, the key users of financial statements—and beneficiaries of financial disclosure—are likely to be owners/investors and creditors.

Financial disclosure addresses the following areas: balance sheet, income statement, statement of cash flows, statement of equity, notes to the financial statements, and accounting policies used. An SME should explicitly state its commitment to high-quality financial reporting in its code of conduct

In July 2009, the International Accounting Standards Board (IASB) issued *IFRS for SMEs*,[10] which we highly recommend for more information on this topic (IASB 2009).

Nonfinancial Disclosure

The general rule for deciding on nonfinancial disclosure and its extent is based on whether the disclosure is required by law or regulations, or by external constituencies to the company. This will mostly depend on the business area the company is active in as well as the development stage of the company.

For instance, a licensed business, such as a financial institution, may have to legally disclose some nonfinancial information to increase market confidence. A company aiming to supply goods through a global supply chain, or aiming to compete in public tenders, may need to provide nonfinancial data on its website.

10   IFRS = International Financial Reporting Standards.

Whatever the reason, companies disclosing nonfinancial data need to follow the general principle of *materiality*. To determine what is material, they should ask three questions:

▶ What factors—what inputs, processes, and outputs and outcomes—influence our ability to create value?

▶ Which stakeholder groups do we depend on in our process of creating value in the short, medium, or long term, or whom are we affecting significantly?

▶ Which factors are sufficiently likely to (and/or could) have a large enough impact on our value creation?

Typical disclosure for investors covers the following broad areas:

▶ State of the company: management team, key personnel, and products and services offered. Some companies may also choose to disclose data on market share, their industry analysis (supply chain, customers, competitors, and so on), and a broad-brush explanation of their strategy.

▶ Ownership: structure and voting rights, articles of association, relevant charters, bylaws, policies, and recent material events/changes.

▶ Governance: such as values and code of conduct/ethics, board size and composition, terms of reference, meeting attendance, minutes, conflicts of interest, board performance assessment, and so on.

It is a good idea to use the company website and other public means to disclose to other stakeholders any information that is not commercially sensitive.

Relationship with big corporations

SMEs that aim to become part of the supply chains of bigger corporations need to get used to the idea of environmental, social, and governance (ESG) disclosures. Also called *sustainability reporting*, this includes disclosure of their environmental-impact hazards, their human health, social, and labor issues and impact on local communities, and their regulatory compliance and liability. (**See Box 3.6.**)

If you are looking to grow through a partnership with an equity investor, be aware that requirements for sustainability reporting may become even more detailed and specific.

Related-party transactions

The RTP policies (**as discussed on pages 59 and 60**) should include clear guidance on disclosure of such transactions. Their proper disclosure is an important element of building trust between various investors and the management of the company.

Box 3.6: Benefits of Sustainability Reporting

Sustainability reporting provides the following benefits:

▶ Helps communicate risk management information to investors
▶ Increases awareness of risks and opportunities
▶ Emphasizes the link between financial and nonfinancial performance
▶ Benchmarks and assesses sustainability performance relative to laws, norms, codes, performance standards, and voluntary initiatives
▶ Helps manage and communicate environmental, social, and governance performance
▶ Improves reputation and brand loyalty

Source: GRI (2013).

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LEADING PRACTICES:
Disclosure and Transparency

Below, we present leading common practices for each SME evolutionary stage, using the categories discussed above:

▶ **Financial Disclosure**

▶ **Nonfinancial Disclosure**

Note that these practices are cumulative: practices for later stages build on the practices of earlier stages. Some recommendations may be implemented more effectively in different stages, depending on the circumstances, or may be implemented as the company is transitioning from one stage to the next. Use your judgment to determine the best timing for your company.

Stage 1: START UP BUSINESS

Financial Disclosure

Prepare basic financial accounts and use this information consistently for registration, reporting, and other purposes. Consistency in maintaining such financial records is important to potential investors and funding institutions, because it allows them to better evaluate the business's performance and future growth potential.

Stage 2: ACTIVE GROWTH

Financial Disclosure

Conduct monthly reconciliation of bank accounts. This simple control activity allows for more effective cash flow management and helps detect and prevent fraudulent activity. (**See *Elements of Internal Controls* on page 53.)**

Ensure timely (monthly or quarterly) dissemination of financial statements to all shareholders.

Nonfinancial Disclosure

Agree with shareholders on key nonfinancial information to be presented to them on a regular basis. The information should include past performance as well as forward-looking issues (risks, opportunities, and so on).

Ensure that information is provided equally to all shareholders.

Develop the public profile of the enterprise and use it consistently for marketing, Web presence, and other business purposes.

Stage 3: ORGANIZATIONAL DEVELOPMENT

Financial Disclosure

Prepare financial statements in accordance with national accounting standards.

Nonfinancial Disclosure

Establish the disclosure function, possibly combining it with a compliance officer, CFO, or company secretary. (**See *Organizational Structure* on page 28.**)

Identify information to be included in briefing papers for the regular meetings with external advisers/advisory board.

Define key nonfinancial information to disclose to the public (for example, performance summary, forward-looking strategies, governance practices, corporate social responsibility practices) and present through accessible channels, such as the company website.

Establish the means to effectively communicate key decisions (strategy, priorities) and other relevant information to all staff.

Make sure there is regular communication of the code of ethics/business-conduct policy. Find ways to reinforce the message regularly.

Stage 4: BUSINESS EXPANSION

Financial Disclosure

Prepare the company's financial reporting in accordance with the IFRS for SMEs or U.S. GAAP (if you currently have or aim to have foreign investors).

Choose the external auditing firm by clearly defined criteria, such as experience, independence, reputation, cost.

Nonfinancial Disclosure

Regularly present all material information to the board in a predefined format and time frame (at least quarterly).

Distribute reports with key information (for example, annual report) to shareholders as required by law and per the shareholder agreement.

Consider what forms of regular voluntary disclosure to stakeholders (beyond those required by law) would be beneficial for the company.

Make sure the company's disclosure function provides for orderly handling of shareholder information requests.

E

Ownership

"I don't know cases of families. . .that had become more united because of money, but I do know of many cases where families destroyed companies because of money."

— **Roque Benavides, CEO, Buenaventura**

Stage 1 START-UP BUSINESS	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
▶ The role and responsibilities of the founder(s) clearly established ▶ Basic understanding of roles of all family members ▶ Shareholder dispute resolution mechanism	▶ The difference between non-family and family issues is acknowledged ▶ Awareness of family succession planning ▶ Annual shareholders' meetings	▶ Clear distinction between the roles of the founder(s), family members, and managers ▶ Clear career paths for non-family executives ▶ Family succession plan ▶ Annual shareholders' meetings include discussions of key decisions made, dividends, and plans	▶ Policies and mechanisms to regulate family members' ownership, employment, and other benefits ▶ All shareholders are regularly updated on company policy, strategy, and results ▶ Mechanism for resolving governance-related disputes

SMEs typically start as sole proprietorships or partnerships of two or three people. As the company develops and shows signs of success, other investors may show interest—first, friends, family members, or managers, and later, professional investors such as private equity funds. These shareholders often have diverging interests and views on the company development. This section discusses how to manage shareholder-related issues for the benefit of a business's long-term development. It looks specifically at the following:

▶ **Shareholder Participation** in determining the future of the company;

▶ **Founder/Family Role** in running the company;

▶ **Shareholder Dispute Resolution** to proactively handle conflicts that can threaten the survival of the company.

Shareholder Participation

Growth in SMEs is often organic and unstructured and can lead to confusion over roles, responsibilities, and scope of authority of shareholders. These issues are intensified in family businesses, where authority, power, and influence are not necessarily related to formal business roles. Therefore, the key focus for Stage 1–2 SMEs should be on providing basic clarity of the shareholders' roles and responsibilities. In Stages 3–4, the emphasis shifts to regulating growing family involvement in the business and balancing the interests of an increasing number of shareholders for the benefit of the company's long-term sustainability.

Evolving Nature of SME Ownership

At the beginning of the lifecycle of an SME, initial shareholders tend to be connected—as acquaintances,

family members, or business partners. Most tend to be involved in the operational matters of the company, acting as both owners and managers. Others frequently "check in" with the company to see what's going on.

Many SMEs start as sole proprietorships or partnerships, but some SMEs start as corporate legal entities, which means that from the beginning they have to comply with the legal requirement to have a board of directors. For those SMEs, the board of directors becomes a formality, without real substance. Early on, this is not a problem—as long as the number of owners is small, they all run or interact with the business, and all have a direct input in shaping the future of the company.

This situation can continue for as long as there is no substantial growth, either of the business or the ownership. However, as soon as the business becomes more complex, the initial owners who do not run the company will gradually start losing the ability to have a full picture and strategic control over the operations. The situation becomes even more complicated if the company brings in external investors. Unlike the founding owners, the new investors do not have inside information about the business and may not have the same level of trust in the capacity of the founder/CEO as the co-founding owners may have.

These changes will make it necessary for the company to formalize the relationship with its investors, with clearly established processes and policies to handle communication flows and strategic decision making. Companies that have boards as a mere formality will have to enable them to effectively fulfill their roles.

For family-owned SMEs, the change in the structure of ownership may also be a product of family members belonging to different generations and branches of the family inheriting the business. As the pool of shareholders grows larger, most of them will end up with a smaller percentage of the company's shares, and issues related to shareholder rights will become more common. These issues can be mitigated by ensuring clear protection of minority shareholders in the business charter, bylaws, and business governance code.

Types of Investors

SMEs might be interested in attracting external investors for reasons beyond access to financing. Investors can bring important connections, knowledge, and expertise to enable the company to fully realize its potential for growth. They typically require representation on the board commensurate with their share of ownership. **Table 3.1 on the next page** describes the common types of investors that SMEs can investigate.

The vast majority of SMEs have friends and family members as partners, especially at the early stages of development. The shareholder relationship often remains highly informal and trust-based. Even in this case it is strongly recommended to clearly spell out some of the key elements of shareholders' rights discussed in this chapter, such as their role in decision making, claiming a profit share, role in the company, and so on. This will enhance trust and provide reasonable insurance against potential misunderstandings and conflicts in the future.

Key Shareholder Rights

All shareholders, regardless of their size, have certain rights, among them:

▶ The right to obtain relevant, material information about the business on a timely, regular basis (**discussed in the section on Disclosure and Transparency, above**);

▶ The right to have a say in the strategic development of the company.

An *annual general meeting* (AGM) provides a vehicle for the sharing of information and the participation of shareholders by allowing them to take the following actions:

▶ Review and approve company results and dividends.

▶ Set company goals on growth, risk, profitability, and liquidity;

- Appoint members of the board of directors;

- Make other key decisions, such as those concerning equity structure, company strategy, and large related-party transactions.

One of the most important issues is minority shareholders' representation on the board. For most SMEs, the founder typically remains the dominant shareholder and can effectively control the board composition. It is a good practice, however, to allow minority shareholders to appoint a director to represent their interests on the board. This position is typically filled by an independent director. Institutional investors generally make their participation conditional on having a nominee director on the board.

As SMEs evolve through the stages of growth, it is important to note that initial owners or investors may no longer adhere to the vision, strategy, or decision processes that were associated with the development of the company. An exit of one or several initial investors is a frequent occurrence, and without an agreed mechanism for the valuation of shares (typically part of the shareholder agreement), a company may be faced with infighting among investors and paralysis of operations. Be clear about who can sell their shares, how much at a time, how often, by what method, and to whom.

In family businesses, the company may establish a shares-redemption fund to buy back any shares that family members would like to liquidate. The aim is to provide liquidity for the shareholders, without undermining the company. The business typically finances such a fund by contributing a small percentage of profits to it every year.

Table 3.1: Types of Investors

STRATEGIC PARTNERS	SMEs can benefit from investment from companies that become strategic partners. An example is a property management company making a strategic investment in a property maintenance company—as one will provide service to the other.
ANGEL INVESTORS	Angel investors typically are people with high net worth, often business people themselves, who provide capital to start-ups, usually in exchange for equity or convertible debt. Angel investors, having taken on considerable risk by investing their personal funds, often offer a great deal of one-on-one support and personal guidance to owners in a bid to support the company's successful growth and development. Hence angle investors typically seek to invest in business fields where they have considerable experience. Angel investors may also work through funds or alliances to help diversify risks.
VENTURE CAPITALISTS	Venture capitalists—a well-known form of funding through a professionally managed fund—look for a high return on investment and have strict procedures to follow. The venture capitalist takes equity, and if a business does not live up to expectations, the venture capitalist can have the company sold to recoup its investment. Venture capitalists typically fund enterprises later in the investment process and, having deeper pockets, invest larger amounts of capital than angel investors.
CROWDFUNDING	Rather than asking one person or a single bank for a large sum of money, a business accessing crowdfunding has the opportunity to ask thousands of people for small amounts of money each. The investment can be in exchange for future products or services, or equity in the company. A relatively new source of funding, it has been used successfully by nontraditional start-up businesses. A strong board can help companies stand out and attract more capital, especially if the boards have independent directors who will represent interests of retail investors.

Founder/Family Role[11]

If the business is successful, the role of owners is bound to evolve along with the evolution of the company. Owners will move from micro to macro positions, leaving operational decision making to professional managers.

Some of these managers might be family members. In fact, the vast majority of SMEs are family businesses. The founders rely heavily on family members' labor, funding, and connections to get the business going, and they plan to pass it to the next generation. SMEs that are family operated benefit from trust-based relationships, informality, and streamlined decision making, which can be an asset in the early stages of company growth. These SMEs can be resilient in crisis, given the trust between related parties—and with generations at stake, the long-term business planning can lead to superior business performance (as outlined in Liu, Yang, and Zhang 2012).

However, while many family businesses are thriving, there are also many that fail to be sustainable in the long term. Indeed, about two-thirds to three-quarters of family businesses either collapse or are sold by the founders during their own tenure. Only 5 percent to 15 percent continue into the third generation in the hands of the descendants of the founders (Neubauer and Lank 1998).

Many of these companies fall victim to weaknesses that are specific to the nature of family businesses, among them:

▶ *Complexity.* Adding family emotions and issues complicates business relations. Also, when family members take on different roles within their business, it sometimes leads to a misalignment of incentives among all family members.

▶ *Informality.* Because most families run their businesses themselves (at least during the first and second generations), they usually show very little interest in setting clearly articulated business practices and procedures. As the family and its business grow larger, this situation can lead to many inefficiencies and internal conflicts.

▶ *Nepotism.* Favoring family members can destroy value or diminish value creation.

These concerns are further compounded by an additional variable: the evolution of ownership as the business passes from the founder to successive generations, bringing changes in the number and nature of shareholders. Also, there will be more possible combinations of roles that different family members can play:

▶ Owning shares in the company but not working for it;

▶ Working for the company but not owning shares;

▶ Owning shares and working for the company.

These factors can seriously complicate both family and business relationships. To address issues and interests of the family as a whole, many family businesses find it useful to develop *family* governance structures that are parallel to the *business* governance structures.

Governance institutions: A family governance structure could take the form of a *family assembly*, which has all family members meeting annually to update each other on how the business is going, to discuss certain issues, and to benefit from the viewpoints of those not formally involved in the governance of the business.

In addition, there may be a *family council*, which acts as an executive committee of the family assembly. It

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11 This subsection is based on the *IFC Family Business Governance Handbook* (IFC 2008), which is freely available online and highly recommended for further study on this topic: **http://www.ifc. org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_ site/ifc+cg/resources/guidelines_reviews+and+case+studies/ ifc+family+business+governance+handbook**.

typically is composed of five to nine elected members, who represent different branches and age groups in the family. This includes members who are employed in the business as well as those who are not.

Family governance policies: The *family constitution* is the most comprehensive type of family governance document. It typically covers the family's values and beliefs (mission statement) and family business principles or policies and can include the following:

▶ *Family shareholding policy*—establishes rules for share ownership and transfer, to ensure that shares are kept in the family when desired (an example is a share redemption fund);

▶ *Family employment policy*—provides guidelines on how family members can gain employment with the company (for example, it might set criteria for educational background and professional experience);

▶ *Family dividend policy*—establishes guiding principles for family dividend payments, to help resolve differing family cash demands;

▶ *Family director nomination policy*—provides guidelines for electing family members to the company board of directors;

▶ *Conflict resolution policy (and committee)*—describes measures to help resolve conflicts between family members, within a defined scope.

Deciding what type of institution to establish and the content of the policies will depend largely (but not exclusively) on the size of the business, the family's stage of development, the number of family members, and the degree of involvement of family members in their business.

Shareholder Dispute Resolution

It is important for the shareholders and directors to ask, "Do we have an adequate mechanism in place to prevent and resolve governance disputes?" James Groton, dispute resolution consultant and arbitrator, emphasizes the importance of this duty.

> *". . .[T]he parties to a business relationship, at the time they enter into that relationship, should always address the subject of how they are going to handle any problems or disputes that may arise between them. At this point they have a unique opportunity to exercise rational control over any disagreements that may arise, by specifying that any disagreements be processed in ways that are likely to avoid litigation, preferably by agreeing on a dispute resolution 'system' that will first seek to prevent problems and disputes, and next establish a process for resolution of any disputes"* Groton and Haapio 2007.

Provisions for how to resolve potential disputes should be included in the shareholder agreement and other relevant company documents. Together, these documents should provide a practical procedural roadmap that makes clear for all disputants how matters will be resolved.

The most effective and efficient way to resolve governance disputes is **mediation**—a voluntary, confidential process whereby a respected impartial third party (mediator) helps the disputing parties work toward a negotiated agreement. The parties in mediation craft the terms of an agreement by consensus, which means they fully control the outcome, unlike outcomes in litigation.

For detailed guidance on setting effective dispute resolution in business, we recommend *Boardroom Disputes: How to Manage the Good, Weather the Bad, and Prevent the Ugly* (IFC 2015a).

Ownership

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LEADING PRACTICES:
Ownership

Below, we present leading common practices for each SME evolutionary stage, using the categories discussed above:

▶ **Shareholder Participation**

▶ **Founder/Family Role**

▶ **Shareholder Dispute Resolution**

Note that these practices are cumulative: practices for later stages build on the practices of earlier stages. Some recommendations may be implemented more effectively in different stages—or, depending on circumstances, as the company is transitioning from one stage to the next. Use your judgment to determine the best timing for your company.

Stage 1: START UP BUSINESS

Founder/Family Role

Define and communicate to all staff the role of the founder(s) in company operations.

Define the role and rights of other family members—and communicate to them as well as to company employees. This issue needs to be addressed not only for family members who are employed in the business but also those not formally involved in running the business. If multiple family members own or are expected to own shares, adopt a formal process to enable them to exit. The aim is to provide liquidity for the family shareholders without undermining the company. For instance, be clear about who can sell their shares, how much at a time, how often, by what method, and to whom.

Shareholder Dispute Resolution

Incorporate shareholder dispute resolution provisions into the shareholder agreement or articles of incorporation.

Stage 2: ACTIVE GROWTH

Shareholder Participation

Hold annual meetings of shareholders to discuss key decisions made, dividends, and plans.

Founder/Family Role

Clearly define and communicate the difference between business and family issues, and the proper channels to address them.

Discuss contingency succession issues internally with the family, and identify possible successors, both in top management and in ownership. (**See *Succession Planning* on page 41.**)

Stage 3: ORGANIZATIONAL DEVELOPMENT

Shareholder Participation

Be sure shareholders meetings are well-organized and function effectively to allow for adequate shareholder participation. In particular:

▶ Provide as much advance notice as is practicable.

▶ Ensure that documentation is professional and distributed in a timely manner.

▶ Make the meeting relevant and interesting; listen to shareholders on voting issues.

Founder/Family Role

Discuss the desirability, or lack of thereof, of family members assuming multiple roles and responsibilities in the business. The decision needs to be clearly communicated inside the business and family.

Create clear functional distinctions between 1) owners (shareholders), 2) employees (especially senior management), and 3) non-employee/non-shareholder family members. Family members "wearing multiple hats" should understand proper modes of behavior and communication in their various roles. In discussing and defining family-member roles, be sure to consider these three dimensions and their points of interaction: 1) the family subsystem, 2) the business subsystem, and 3) the ownership subsystem.

Identify clear career paths for non-family executives and technical specialists. Review the role of job mastery as a motivating factor. (**See *Human Resources Planning* on page 45.**)

Develop and communicate the family ownership (and management, if applicable) succession plan. (**See *Succession Planning* on page 41.**)

Ownership

E

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Shareholder Participation

Define effective ways to regularly update all shareholders on company policies, strategy, and results. Ensure that these means of communication do not create an additional burden for shareholders (for example, multiple mailings or e-mailings).

Founder/Family Role

Develop and communicate policies, mechanisms, and structures to regulate decisions that might affect family members' ownership, employment, dividends, and other benefits. This should include defining specific training and education needs for current and future employed family members. Consider establishing a shares-redemption fund.

Shareholder Dispute Resolution

Expand dispute-resolution provisions to include the leading role of the board in governance-related conflict resolution, and specify approaches to be taken in case of conflicts with different stakeholders, such as shareholders or managers. Incorporate relevant provisions into company bylaws.

Appoint someone to oversee the development and implementation of the governance dispute-resolution strategy and policies. A board member, the chair, a board committee, the CEO, or possibly a senior executive could assume this responsibility.

Chapter 4

Conclusion

Conclusion

The goal of this Guidebook is to help SMEs gain a better grasp of the challenges they face—and how to tackle them from a corporate governance perspective. It is built on the innovative concept of tying governance recommendations to growth stages, which helps entrepreneurs take a pragmatic approach to progressively adopting better governance policies, practices, and structures as the business evolves. The advice in this Guidebook is intended as a general guidance and not as a panacea. It needs to be adapted to the specific context of a given company and its business environment.

The **Appendix** provides an **SME governance action planning tool** that summarizes the recommendations of this Guidebook. It presents that information in a workbook format designed to help you develop a tailored governance-improvement plan for your company. The ultimate goal is for your company to become more competitive and to grow sustainably.

rockstar

Case Study: We Say Goodbye—Investors Say Hello!

This Guidebook has described a wide range of recommendations that the IFC team provided for Rockstar Clothing. At the beginning, the company needed massive changes. Our challenge: where to start?

IFC recommended that Rockstar prioritize three actions to address pressing immediate issues as well as to enable the company to achieve positive changes down the road:

1. Establish an executive management committee, supported by clear authority and reporting lines. This action requires no additional resources and will help alleviate acute and obvious management challenges. The management committee should be empowered to start developing a proper business plan.

2. Hire a recruiting company to find a competent HR manager. The company's HR policies need to be reorganized and clearly defined to attract high-caliber staff, especially for the CFO position, and to address key-persons risks (most notably for the designer and CEO).

3. Hire a consultant to establish basic computer-enabled internal control processes to provide accurate and timely information on the state of the business. This will enable better management of available resources and serve as a prerequisite for attracting investment.

The company accepted the recommendations and embarked on an ambitious plan to reinvent itself with the goal of achieving Rami Bahgat's vision of opening 100 stores all over Egypt. The last time we heard from the company, in late 2018, it had managed to raise financing of approximately $10 million from a private equity firm through a competitive process.

This turnaround has Rockstar Clothing looking good! (The suits that Rami creates look very nice, too.)
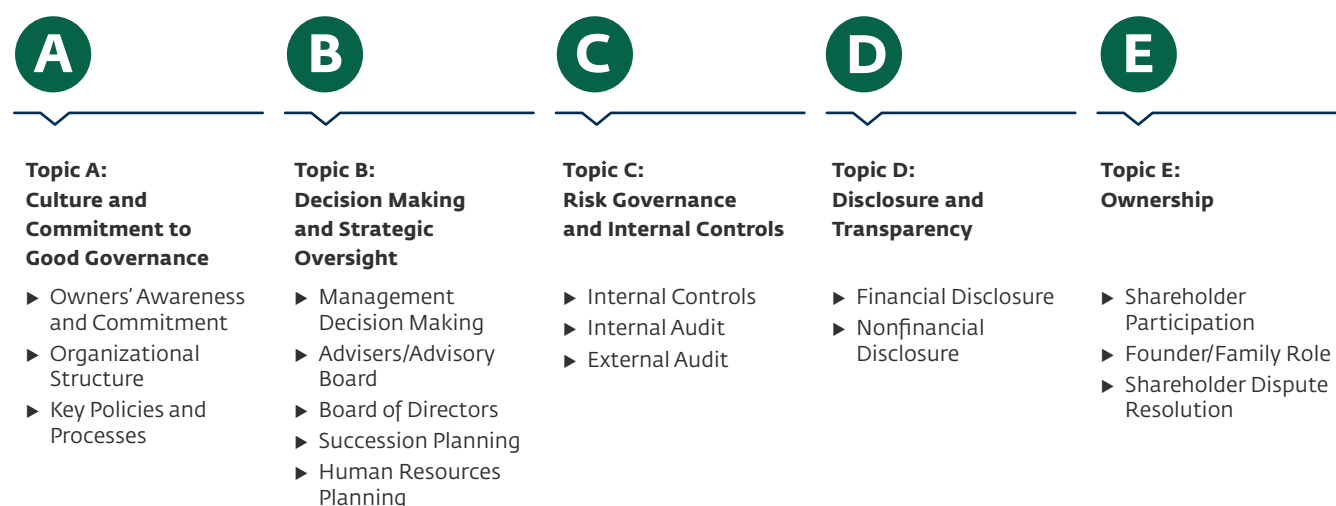
Appendix
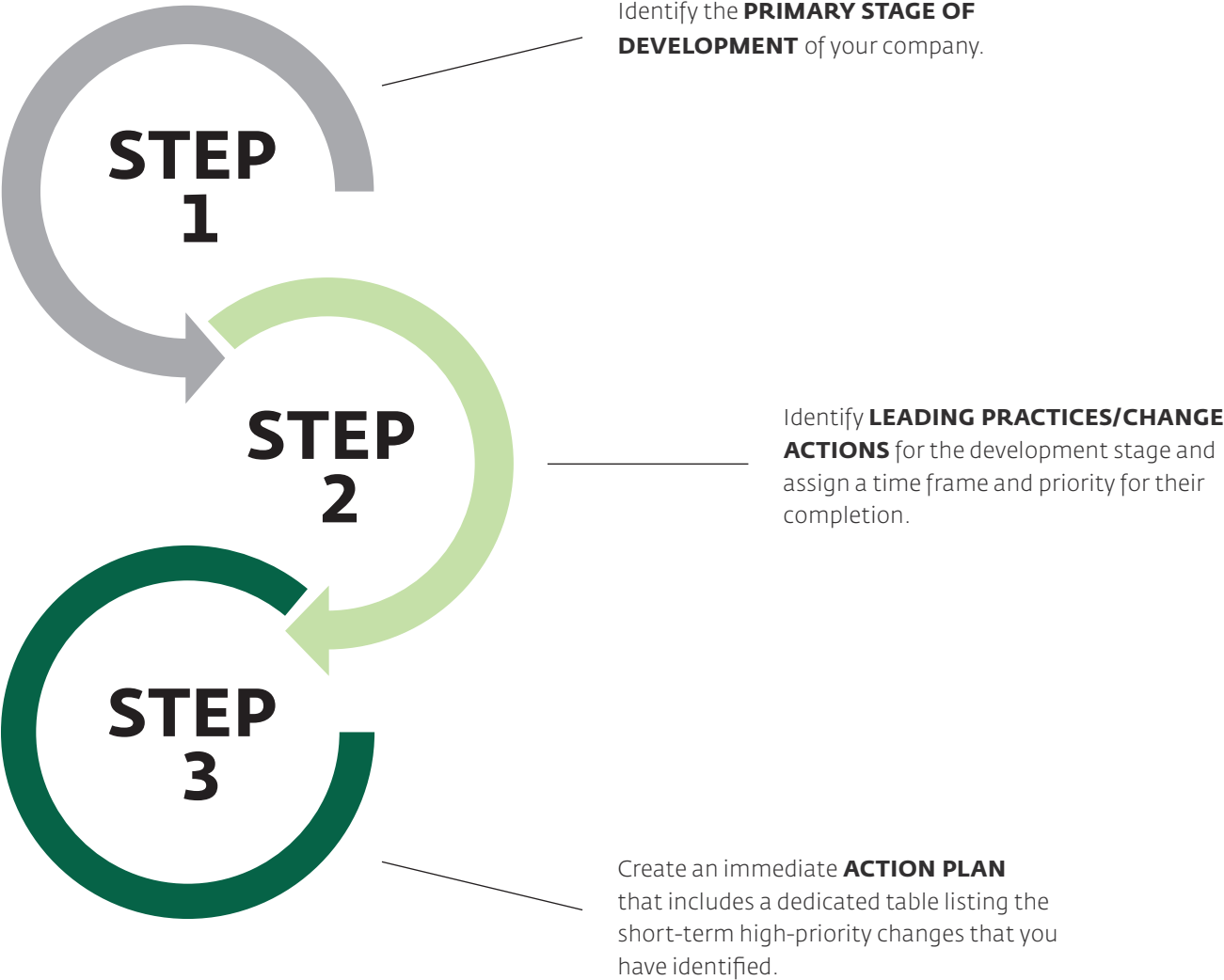
SME Governance Action Planning Tool

Appendix

SME Governance Action Planning Tool

This tool summarizes the key recommendations of the SME Guidebook to help you identify high-priority actions appropriate for your SME's stage of growth. The diagnostic is organized around five governance topics and their subtopics. (*See Figure A.1.*)

Figure A.1: Governance Topics and Subtopics

A	**B**	**C**	**D**	**E**
Topic A: **Culture and Commitment to Good Governance**	**Topic B:** **Decision Making and Strategic Oversight**	**Topic C:** **Risk Governance and Internal Controls**	**Topic D:** **Disclosure and Transparency**	**Topic E:** **Ownership**
▶ Owners' Awareness and Commitment ▶ Organizational Structure ▶ Key Policies and Processes	▶ Management Decision Making ▶ Advisers/Advisory Board ▶ Board of Directors ▶ Succession Planning ▶ Human Resources Planning	▶ Internal Controls ▶ Internal Audit ▶ External Audit	▶ Financial Disclosure ▶ Nonfinancial Disclosure	▶ Shareholder Participation ▶ Founder/Family Role ▶ Shareholder Dispute Resolution

The tool provides a **THREE-STEP PROCESS** *for developing a priority action plan for improved governance:*

STEP 1

Identify the **PRIMARY STAGE OF DEVELOPMENT** of your company.

STEP 2

Identify **LEADING PRACTICES/CHANGE ACTIONS** for the development stage and assign a time frame and priority for their completion.

STEP 3

Create an immediate **ACTION PLAN** that includes a dedicated table listing the short-term high-priority changes that you have identified.

Appendix

5

Step 1

My Company's Primary Stage of Development

Use the worksheet on the next page to identify the stage of development of your company. Circle the component description that most closely matches your company's current state. Then choose the stage that has the most matches.

Important: If your company is in the process of moving from one stage to the next, you should use the earlier stage as the primary stage of development.

Worksheet A.1:
Identify the Stage of Development

Defining Factors/ Parameters	Stage 1 START-UP	Stage 2 ACTIVE GROWTH	Stage 3 ORGANIZATIONAL DEVELOPMENT	Stage 4 BUSINESS EXPANSION
Size* (# of employees)	Small (e.g., <50)	Small to Medium (e.g., 50–75)	Medium (e.g., 76–150)	Medium Growing (e.g., 151–250)
Enterprise Focus	Developing products, testing the market	Sales and growth, increasing variety of products, creating client base	Optimizing own structure/processes after growth	Further growth, supported by improved internal organization and processes
A **Culture and Commitment to Good Governance** (Policies, processes, and organizational structure)	▶ Small multitasking team ▶ High degree of informality ▶ Few systems, established "on the go"	▶ Team is growing— distinct functions and organizational structure start emerging ▶ Simple systems to enable functions to collaborate	▶ Increased professionalization of functions ▶ Formalizing organizational structure, policies, and procedures	▶ Continuation of trends started in Stage 3
B **Decision Making and Strategic Oversight** (Decision-making process and bodies, leadership style)	▶ Highly centralized decision making by the founder(s) ▶ Autocratic leadership style	▶ Emergence of delegation to management ▶ Consultative leadership style—largely autocratic but with input from key managers and advisers	▶ Professional managers are hired ▶ Decentralization of authority through division /functional management ▶ Collaborative management style	▶ Separation of strategic and operational decision making ▶ Institutional decision-making style, based on defined organizational structure, roles, and procedures
C **Risk Governance and Internal Controls** (Internal checks and balances)	▶ Founders are fully involved in operations— limited need for checks and balances	▶ Introducing internal controls to support delegation of authority	▶ Detailing authorities and accountability ▶ Systems are formalized and automated ▶ Developing practices to control main operational risks	▶ Focus on proactive and strategic risk management
D **Disclosure and Transparency** (Communication with internal and external stakeholders)	▶ Everyone knows everything	▶ Silos—good within, but challenging between silos ▶ Basic external information shared on products offered	▶ Internally: improving cross-divisional/ functional information sharing ▶ Enhanced external business-related information	▶ Internally: management, board, and shareholders communicate ▶ Externally: targeted information for different stakeholders
E **Ownership** (Founders/Shareholders/ Family)	▶ Single owner or couple of individuals ▶ Founders personally control every aspect of business	▶ New minority shareholders possible (internal or related) ▶ Founders remain dominant and fully engaged ▶ Increasing number of family members getting involved in operations	▶ New minority shareholders possible (internal or related) ▶ New investors informally influence strategy but are not directly involved in operations ▶ (If a major investor enters—company moves to Stage 4)	▶ Common options: a. Founders, PE, and other investors b. Growing family ownership/ generational change c. Go Public (IPO) ▶ Investors require tools for control and direction of the company

*May vary by industry, so this guidance is intended to be broadly indicative.

Step 2

Governance Leading Practice – Identify Relevant Practices

Use Worksheets A.2–A.6, on the next page, to identify relevant governance practices for your company.

Review the Leading Practices/Change Actions. Fill in the check-circle on the left if the practice has already been satisfactory implemented. If it has not been implemented or needs further improvement, assign a time frame and priority to it, as illustrated in Figure A.2.

Figure A.2: Example Worksheet for Leading Practices and Change Actions

Time Frame: (ST) = <6 mos.; (MT) =6–12 mos.; (LT) = > 1 yr.
Priority: (H) = High; (M) = Medium; (L) = Low

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Owners' Awareness and Commitment** ● **A1-1.** Officially register the business with proper authorities (as a company or sole entrepreneurship) to ensure separation of the business from the person	(ST) (MT) (LT)	(H) (M) (L)
	Organizational Structure ○ **A1-2.** Identify core business functions needed, and distribute them among your multitasking team.	● (MT) (LT)	(H) ● (L)
	Key Policies and Processes ● **A1-3.** Adopt the Articles of Association.	(ST) (MT) (LT)	(H) (M) (L)

It is important to be alert to the following:

▶ These practices are cumulative: practices for later stages build on the practices of the earlier stages. So always check to be sure your company has covered the actions recommended for the earlier stage(s).

▶ The staging of actions is indicative. Also, many companies are in the process of moving from one stage to the next. Therefore, in some circumstances certain practices or actions may be done sooner or later than recommended. Use your judgment to decide the best timing for your company.

Worksheet A.2:
Topic A. Culture and Commitment to Good Governance

A

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Owners' Awareness and Commitment**		
	◯ **A1-1.** Officially register the business with proper authorities (as a company or sole entrepreneurship) to ensure separation of the business from the person.	(ST) (MT) (LT)	(H) (M) (L)
	Organizational Structure		
	◯ **A1-2.** Identify core business functions needed, and distribute them among your multitasking team.	(ST) (MT) (LT)	(H) (M) (L)
	Key Policies and Processes		
	◯ **A1-3.** Adopt the Articles of Association.	(ST) (MT) (LT)	(H) (M) (L)
Stage 2	**Owners' Awareness and Commitment**		
	◯ **A2-1.** Develop a basic statement on vision, mission, and core values, and communicate it to staff.	(ST) (MT) (LT)	(H) (M) (L)
	Organizational Structure		
	◯ **A2-2.** Ensure that the core functions needed for the company to grow have been filled through direct hiring or outsourcing. Develop clear job descriptions.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **A2-3.** Define, document, and communicate to all staff the organizational structure, with lines of authority and reporting.	(ST) (MT) (LT)	(H) (M) (L)
	Key Policies and Processes		
	◯ **A2-4.** Develop basic policies, where applicable, to regulate the authority/function.	(ST) (MT) (LT)	(H) (M) (L)
Stage 3	**Owners' Awareness and Commitment**		
	◯ **A3-1.** Signal the intent to develop effective governance by discussing its importance with managers and staff.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **A3-2.** Articulate long-term vision for the company—to be used for staffing, strategic planning, and other purposes.	(ST) (MT) (LT)	(H) (M) (L)
	Organizational Structure		
	◯ **A3-3.** Appoint a person to have responsibility for improving governance practices and compliance. This could be a fulltime position (company secretary) or part-time function for one of the executives or a lawyer.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **A3-4.** Conduct periodic reviews to evaluate the existing organizational structure and reporting lines.	(ST) (MT) (LT)	(H) (M) (L)
	Key Policies and Processes		
	◯ **A3-5.** Document and periodically review the efficiency of core processes (accounting, procurement, etc.). Establish basic communication channels to communicate the shortcomings of core processes.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **A3-6.** Start producing a simple calendar of corporate events (such as team meetings, participation of company representatives in conferences and public forums, etc.).	(ST) (MT) (LT)	(H) (M) (L)
Stage 4	**Owners' Awareness and Commitment**		
	◯ **A4-1.** Establish the company secretary function to ensure effective work of the board, help the board improve governance practices and compliance, and organize annual shareholder meetings.	(ST) (MT) (LT)	(H) (M) (L)
	Organizational Structure		
	◯ (Board established—see Topic B)	(ST) (MT) (LT)	(H) (M) (L)
	Key Policies and Processes		
	◯ **A4-2.** Develop an action plan that includes explicit actions, timing, and responsibility to improve governance.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **A4-3.** Formalize governance provisions with participation of all shareholders and key stakeholders. Include them in the Articles of Association, Shareholder Agreement, and Employee Handbook.	(ST) (MT) (LT)	(H) (M) (L)

Appendix

5

Worksheet A.3:
Topic B. Decision Making and Strategic Oversight

B

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Management Decision Making**		
	○ **B1-1.** Conduct individual consultations with key executives before making major decisions.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B1-2.** Define and communicate authority limits for key personnel, such as amounts of expenditures that require CEO authorization.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	Advisers/Advisory Board		
	○ **B1-3.** Involve external trusted advisers (even if informal) to discuss strategic issues.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
Stage 2	**Management Decision Making**		
	○ **B2-1.** Develop an authority matrix that defines key decisions and which business units or individuals are authorized to make them. This should include decisions for the founder/shareholders, board (if one exists), CEOs, key executives, and technical specialists.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B2-2.** Management should meet regularly as a group to collaboratively review operational issues and progress against plans, to identify risks/issues, and to take decisions. The group is engaged by CEO/owners for consultations on strategic issues, as needed.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	Advisers/Advisory Board		
	○ **B2-3.** Articulate areas/topics of needed external expertise (providing input on company strategy, financing plans, new markets and products, technical issues, company structure, business relationships, external company profile, coaching of executives, or other).	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B2-4.** Define the role and formalize involvement of the needed external advisers. Make sure the advisers understand their role and are engaged effectively to add value to the company.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	Succession Planning		
	○ **B2-5.** Create a contingency/business continuity plan for the CEO and other key persons, which describes a course of immediate action in case of sudden departure or unavailability.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	Human Resources Planning		
	○ **B2-6.** Develop a simple means of communicating to staff the key decisions, policies, and strategies (e.g., formal e-mail form, circulars).	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B2-7.** Document HR function and job descriptions to ensure that all key roles are filled (or outsourced).	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B2-8.** Develop internal (or outsourced) expertise on management reporting and analytics—to help with cost control and strategic decision making.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
Stage 3	**Management Decision Making**		
	○ **B3-1.** Set up a formal executive committee (the CEO and key senior-level executives). Ensure that the committee has clear terms of reference (TORs).	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B3-2.** The executive committee 1) meets weekly/biweekly on operational issues and 2) has dedicated sessions to focus exclusively on strategic issues, with a set agenda (strategic retreats, 2–4 times a year).	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	○ **B3-3.** At executive committee meetings (e.g., monthly or quarterly), review progress against the plans, and update plans as necessary.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ
	Advisers/Advisory Board		
	○ **B3-4.** Consider whether setting up a formal advisory board would add value to the company. If so, formalize the arrangement and communicate it to all relevant stakeholders.	ⓈⓉ ⓂⓉ ⓁⓉ	Ⓗ Ⓜ Ⓛ

Worksheet A.3:

Topic B. Decision Making and Strategic Oversight (continued)

B

Time Frame: (ST) = <6 mos.; (MT) =6–12 mos.; (LT) = > 1 yr.
Priority: (H) = High; (M) = Medium; (L) = Low

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 3	**Succession Planning**		
	○ **B3-5.** Develop a basic succession-planning framework for senior management, to ensure timely preparation of a talent pool.	(ST) (MT) (LT)	(H) (M) (L)
	Human Resources Planning		
	○ **B3-6.** Make the HR function a strategic partner (and/or part) of the strategic management team (e.g., helping design effective sourcing and retention strategies, compensation and benefits programs, professional development programs, and performance management systems).	(ST) (MT) (LT)	(H) (M) (L)
	○ **B3-7.** Expand the job descriptions for every position to form detailed TORs that include the qualities and qualifications required. Review the current staff for fit with the TORs.	(ST) (MT) (LT)	(H) (M) (L)
	○ **B3-8.** Design an incentives system to attract high-caliber talent and motivate them to perform (mastery, autonomy, purpose), including clear professional and career-growth opportunities, performance-based recognition, and incentives (bonuses, stock options, profit sharing, etc.).	(ST) (MT) (LT)	(H) (M) (L)
	○ **B3-9.** Address personnel retention factors with meaningful engagement from the staff: attractive work environment, internal company policies, competitive compensation and benefit package.	(ST) (MT) (LT)	(H) (M) (L)
Stage 4	**Board of Directors**		
	○ **B4-1.** Clearly define the role of the board, especially in relation to management, and include directors' duties and responsibilities to the company and shareholders in the board charter and director appointment letter.	(ST) (MT) (LT)	(H) (M) (L)
	○ **B4-2.** Determine the skills required for the board to fulfill its duties, given the strategic direction of the company, and evaluate the existing board skills and gaps.	(ST) (MT) (LT)	(H) (M) (L)
	○ **B4-3.** Ensure that the board has an appropriate mix of directors, considering skill sets, professional background, personal attributes, diversity (gender, age, etc.), and balance of executive, non-executive, and independent directors.	(ST) (MT) (LT)	(H) (M) (L)
	○ **B4-4.** Create effective and efficient board procedures:	(ST) (MT) (LT)	(H) (M) (L)
	• Allow enough time for effective discussion and input from all directors.		
	• Provide a focused agenda for each meeting, based on the annual board calendar.		
	• Maintain a balance between management presentations and board discussions, and between reviewing past performance and strategic planning.		
	• Distribute action-orientated and concise board briefing papers at least five business days before board meetings.		
	• Take and approve minutes (discussions, opinions, and decisions). Use them to ensure diligent follow-up.		
	Succession Planning		
	○ **B4-5.** Develop strategic succession plans for the CEO, key executives, and technical specialists (to include immediate, mid-, and long-term succession).	(ST) (MT) (LT)	(H) (M) (L)

Worksheet A.4:
Topic C. Risk Governance and Internal Controls

C

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Internal Controls**		
	○ **C1-1.** Ensure that the company complies with relevant laws and regulations.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C1-2.** Separate the cash sources and bank accounts of the company from the personal sources and accounts of the founders.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C1-3.** Routinely monitor and analyze cash flow needs to effectively plan working capital and financing needs and investment strategies.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C1-4.** Conduct a basic valuation exercise to understand the total net worth of the enterprise.	(ST) (MT) (LT)	(H) (M) (L)
Stage 2	**Internal Controls**		
	○ **C2-1.** Create a mechanism for reporting fraud and abuses (whistleblower).	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-2.** Identify potential business risks, assess their impact, and develop corresponding mitigation actions (with "owners to track progress").	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-3.** Integrate basic risk-based controls into the business processes (e.g., approval limits, separation of authority, verifications, etc.).	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-4.** Identify critical key-person risk positions, designate backup/deputy staff for key functions/technical specialists, and ensure that they are building needed skills and expertise.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-5.** Articulate key principles of business conduct, covering at a minimum the conflicts of interests and related-party transactions, and communicate them regularly to staff.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-6.** Define signatory authority over bank accounts and control over cash management, with thresholds, delegation, and segregation of duties.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-7.** Ensure that sound bookkeeping, accounting policies, and reports have been put in place, with all investments and loans/credits recorded.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-8.** Make cash flow reports and forecasts part of planning discussions to determine future financing needs and drive investment decisions. Ensure that any investments take into account cash flow needs (riskiness, terms, maturities, liquidity).	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-9.** Document clear TORs for the IT function to ensure that all key IT needs are addressed to support further growth of the company. Consider which IT functions should be in-house versus outsourced.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C2-10.** Make sure the IT system for generating data and reports is secure; develop formal safeguard processes for administering security and *business continuity/disaster recovery*.	(ST) (MT) (LT)	(H) (M) (L)
Stage 3	**Internal Controls**		
	○ **C3-1.** Create policies and procedures to monitor and mitigate strategic and operational risks in accordance with the business vision and plans. The executive committee should play the key role.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C3-2.** Define authority and limits of business units, their reporting lines, and guidelines on key processes, to create a path of accountability for every project and activity.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C3-3.** Develop a detailed code of ethics and principles of business conduct, use them in the induction process, and reinforce them regularly in communication with staff.	(ST) (MT) (LT)	(H) (M) (L)
	○ **C3-4.** Establish appropriate remedial actions for violations of the code of conduct, and communicate throughout the organization the results/consequences of noncompliance. Ensure that penalties for breaches are clear and effective.	(ST) (MT) (LT)	(H) (M) (L)

Worksheet A.4:

Topic C. Risk Governance and Internal Controls (continued)

C

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 3	**C3-5.** Hire a professional CFO. (If there are external investors, this should be in consultation with them.)	(ST) (MT) (LT)	(H) (M) (L)
	C3-6. Develop a simple IT strategy to anticipate future business needs (functionality needs, infrastructure needs), and prioritize system initiatives over the short and medium terms to better plan capital requirements.	(ST) (MT) (LT)	(H) (M) (L)
	C3-7. Conduct an independent IT audit to make sure the systems are secure and can support the organization's goals and objectives.	(ST) (MT) (LT)	(H) (M) (L)
	Internal Audit		
	C3-8. Establish an internal audit function, coordinating with compliance and risk functions. It can be in-house, outsourced, or co-sourced (use an external firm to work with internal staff to train and bolster expertise). The owners should ensure maximum possible independence of internal audit to assure full transparency of risks/problems that need to be addressed.	(ST) (MT) (LT)	(H) (M) (L)
	C3-9. Ensure that Internal audit is looking at high-risk areas of the business to give added assurance—and consider ex post or less intensive monitoring for low-risk areas to make best use of audit time/resources.	(ST) (MT) (LT)	(H) (M) (L)
Stage 4	**Internal Controls**		
	C4-1. Management (executive committee) regularly reviews progress against the business plan and identifies and addresses risks, with appropriate internal controls.	(ST) (MT) (LT)	(H) (M) (L)
	C4-2. The board regularly ensures that the company has a sound system of internal controls (e.g., based on COSO).	(ST) (MT) (LT)	(H) (M) (L)
	C4-3. Establish IT systems to record and display sales and accounts and accurately estimate accruals and revenue at any given time. The system should be robust to protect against unauthorized use and to flag potentially problematic transactions.	(ST) (MT) (LT)	(H) (M) (L)
	Internal Audit		
	C4-4. Have internal audit report functionally to the board of directors or a committee of the board of directors (typically the audit committee), and not to the CEO except for administrative purposes. Ensure that audit plans are approved by the board.	(ST) (MT) (LT)	(H) (M) (L)
	C4-5. Ensure that the internal audit coordinates with the external auditor.	(ST) (MT) (LT)	(H) (M) (L)
	External Audit		
	C4-6. Appoint a recognized external auditor. Make sure the external auditor reviews and reports on significant control deficiencies.	(ST) (MT) (LT)	(H) (M) (L)
	C4-7. Ensure independence of the external auditor by restricting it from providing other services that may cause conflicts of interest (e.g., consulting, tax services).	(ST) (MT) (LT)	(H) (M) (L)
	C4-8. Consider rotation of the auditor (or at least the senior audit partner) on a periodic basis (e.g., every three years).	(ST) (MT) (LT)	(H) (M) (L)

Appendix

5

Worksheet A.5:
Topic D. Disclosure and Transparency

D

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Financial Disclosure**		
	◯ **D1-1.** Prepare basic financial accounts.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D1-2.** Use the financial information consistently for registration, reporting, and other purposes.	(ST) (MT) (LT)	(H) (M) (L)
Stage 2	**Financial Disclosure**		
	◯ **D2-1.** Conduct monthly reconciliation of bank accounts, and provide the results to the founders.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D2-2.** Ensure timely (monthly or quarterly) dissemination of financial statements to all shareholders.	(ST) (MT) (LT)	(H) (M) (L)
	Nonfinancial Disclosure		
	◯ **D2-3.** Agree with shareholders on key nonfinancial information to be presented to them on a regular basis. The information should include past performance as well as forward-looking issues (risks, opportunities, etc.).	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D2-4.** Ensure that information is provided equally to all shareholders.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D2-5.** Develop the public profile of the enterprise and use it consistently for marketing, Web presence, and other business purposes.	(ST) (MT) (LT)	(H) (M) (L)
Stage 3	**Financial Disclosure**		
	◯ **D3-1.** Prepare financial statements in accordance with national accounting standards.	(ST) (MT) (LT)	(H) (M) (L)
	Nonfinancial Disclosure		
	◯ **D3-2.** Appoint the person or establish the disclosure function responsible, possibly combining with a CFO, compliance officer, or company secretary.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D3-3.** Identify information to be included in briefing papers for the regular meetings with external advisers/advisory board.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D3-4.** Define key nonfinancial information to disclose to the public (e.g., performance summary, forward-looking strategies, corporate governance practices, CSR practices), and present through accessible channels, such as the company website.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D3-5.** Establish means to effectively communicate key decisions (strategy, priorities) and other relevant information to all staff.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D3-6.** Make sure to regularly communicate the code of ethics/business conduct policy. Find ways to reinforce the message regularly.	(ST) (MT) (LT)	(H) (M) (L)
Stage 4	**Financial Disclosure**		
	◯ **D4-1.** Prepare the company's financial reporting in accordance with the IFRS for SMEs or U.S. GAAP (if having/seeking foreign investors).	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D4-2.** Choose the external auditing firm by clearly defined criteria, such as experience, independence, reputation, cost.	(ST) (MT) (LT)	(H) (M) (L)
	Nonfinancial Disclosure		
	◯ **D4-3.** Regularly present all material information to the board in a predefined format and time frame (at least quarterly).	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D4-4.** Distribute reports with key information (for example, annual report) to shareholders as required by law and per the shareholder agreement.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D4-5.** Consider which forms of regular voluntary disclosure to stakeholders (beyond those required by law) would be beneficial for the company.	(ST) (MT) (LT)	(H) (M) (L)
	◯ **D4-6.** Make sure the company's disclosure function provides for orderly handling of shareholder information requests.	(ST) (MT) (LT)	(H) (M) (L)

Worksheet A.6:
Topic E. Ownership

E

SME Stage	Leading Practice/Change Actions	Time Frame	Priority
Stage 1	**Founder/Family Role**		
	○ **E1-1.** Define and communicate to all staff the role of the founder(s) in company operations.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E1-2.** Define the roles and rights of other family members and communicate them to the family members and company employees.	(ST) (MT) (LT)	(H) (M) (L)
	Shareholder Dispute Resolution		
	○ **E1-3.** Incorporate shareholder dispute resolution provisions into the shareholder agreement or articles of incorporation.	(ST) (MT) (LT)	(H) (M) (L)
Stage 2	**Shareholder Participation**		
	○ **E2-1.** Hold annual meetings of shareholders to discuss key decisions made, dividends, and plans.	(ST) (MT) (LT)	(H) (M) (L)
	Founder/Family Role		
	○ **E2-2.** Clearly define and communicate the difference between business and family issues—and the proper channels to address them.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E2-3.** Discuss contingency succession issues internally with the family, and identify possible successors, both in top management and in ownership.	(ST) (MT) (LT)	(H) (M) (L)
Stage 3	**Shareholder Participation**		
	○ **E3-1.** Shareholder meetings should be well-organized and function effectively to allow for adequate shareholder participation. In particular: • Provide as much advance notice as is practicable. • Ensure that documentation is professional and distributed in a timely manner. • Make the meeting relevant and interesting; listen to shareholders on voting issues.	(ST) (MT) (LT)	(H) (M) (L)
	Founder/Family Role		
	○ **E3-2.** Discuss the desirability, or lack of thereof, of family members assuming multiple roles and responsibilities in the business. The decision needs to be clearly communicated within the business and family.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E3-3.** Create clear functional distinctions between 1) owners (shareholders), 2) employees (especially senior management), and 3) non-employee/non-shareholder family members. Family members "wearing multiple hats" should understand proper modes of behavior and communication in their various roles.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E3-4.** Identify clear career paths for non-family executives and technical specialists.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E3-5.** Develop and communicate the family ownership (and management, if applicable) succession plan.	(ST) (MT) (LT)	(H) (M) (L)
Stage 4	**Shareholder Participation**		
	○ **E4-1.** Define effective ways to regularly update all shareholders on company policies, strategy, and results. Ensure that such ways do not create an additional burden for shareholders.	(ST) (MT) (LT)	(H) (M) (L)
	Founder/Family Role		
	○ **E4-2.** Develop and communicate policies, mechanisms, and structures to regulate decisions that might affect family members' ownership, employment, dividends, and other benefits. This should include defining specific training and education needs for current and future employed family members.	(ST) (MT) (LT)	(H) (M) (L)
	Shareholder Dispute Resolution		
	○ **E4-3.** Expand dispute resolution provisions to include the leading role of the board.	(ST) (MT) (LT)	(H) (M) (L)
	○ **E4-4.** Appoint somebody to be in charge of implementing governance dispute resolution strategy and policies.	(ST) (MT) (LT)	(H) (M) (L)

Appendix

5

Step 3

My Company's Governance Action Plan

*Identify **high-priority action items**—to be taken in the **short term**, based on the recommended actions highlighted in Step 2. Use Worksheet A.7 to identify, refine, and prioritize your short-term action items.*

First, list at least one item in each category. Then review the lists, with the objective of grouping the actions into broader action categories, preferably putting together actions that will be mutually supportive. We recommend that your final list include no more than a total of five action items—to keep the list realistic and manageable.

Worksheet A.7:
Short-Term High-Priority Action Items

Governance Topic	Action Item	Responsible	Date
A **Topic A:** **Culture and Commitment to Good Governance**			
B **Topic B:** **Decision Making and Strategic Oversight**			
C **Topic C:** **Risk Governance and Internal Controls**			

Appendix

5

Worksheet A.7:
Short-Term High-Priority Action Items (continued)

Governance Topic	Action Item	Responsible	Date
D **Topic D: Disclosure and Transparency**			
E **Topic E: Ownership**			

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