

# Small and medium enterprises in kenya economics essay



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## **1. 0 Introduction**

Small and Medium Enterprises (SMEs) are critical for developing countries because of their role in economic growth and poverty reduction. As companies globally face issues relating to transparency, accountability and timely disclosure of material information, the concept of corporate governance and business ethics has gained significant importance. SMEs in developing countries face a number of challenges including access to finance both domestically and internationally as well as developing international trade linkages. Developing entrepreneurial culture and ethical business environment are also important challenges. The main underlying constraint to their growth is lack of corporate governance structure. There is generally a lack of awareness among these enterprises regarding significance of corporate governance and if there is awareness, there is a general aversion to adopting these practices because of the high cost of implementation.

This study will analyse the issues facing SMEs in Kenya and the need for embracing corporate governance and ethical business practices.

## **Background of the Study**

Following on the large numbers of corporate collapses and scandals during the last decade a considerable attention has been given in studying corporate governance practices of large firms around the world. There is a concern of managing the large corporation and aligning the interest of shareholders with management since the idea of ' Modern Corporation' was developed. However, less attention is given on corporate governance practices in Small and Medium Sized Enterprises (hereinafter referred as

SMEs). Thus far, research on corporate governance of SMEs is limited compared to research on large firms (Dyer, 2003; Smith, 2007). There is a school of thought which claims that corporate governance problems may not exist within SMEs as ownership control is considered to be strong in these firms and the agency problems are therefore less likely to exist while another school of thought which considers corporate governance problems may equally exist within SMEs. Abor and Adjasi (2007) argue that there is a global concern for the application of corporate governance practices in small and medium sized firms. They maintain that good corporate governance practices helps Small and Medium Sized firms to obtain funds from investors and financial institutions. They further argue that: “ Entrepreneurial firms need access to resources for growth. They need inputs on business operations, good strategy and best practices in the industrial sector. These resources can be provided for through the presence of non-executive directors or external board members as in the case of listed firms”.

This study will be geared towards understanding the benefits that SMEs derive from the practice of good corporate governance in Kenya.

## **Small and Medium Sized Enterprises**

It is noted by Tambunan (2008) that Small and Medium Enterprises (SMEs) play a vital role in economic development, as they have been the main source of employment generation and output growth, both in developing as well as in developed countries. In developing countries, the role of SMEs becomes more crucial as they have the potential for the improvement of income distribution, employment creation, poverty reduction and export

growth. It also leads to the development of entrepreneurship, industry and the rural economy.

The term “SME” encompasses a broad spectrum of definitions. The definition varies from country to country. Generally these guidelines are based upon either headcount or sales or assets. For example the Inter-American Development Bank defines SMEs as having a maximum of 100 employees and less than \$3 million in revenue. In Europe, they are defined as having manpower fewer than 250 employees and United States define them with employees less than 500 (Natarajan & Wyrick, 2011). As general guidelines, the World Bank defines SMEs as those enterprises with a maximum of 300 employees, \$15 million in annual revenue, and \$15 million in assets. In Kenya, there are different definitions of SMEs which are yet to be consolidated. For example, a national baseline survey of MSEs carried out in 1999 defines a small enterprise as one which employs 6-10 people while a medium one is expected to have 11-100 employees (CBS et al., 1999).

Kachembere (2011), notes that SMEs are playing pivotal role in promoting grassroots economic growth and equitable sustainable development. It is not only the fact that high rates of economic growth contribute to economic and social development and poverty reduction. Recent studies show that economic growth of any country is closely linked with SME development. For example, as noted by Beck (2005) there is a robust, positive relationship between the relative size of the SME sector and economic growth. Also as noted by Ayyagari (2007), the contribution of formal SMEs in high - income countries amount to almost 50 percent of GDP on an average. It is also

important to note that the majority of employment generation is through the <https://assignbuster.com/small-and-medium-enterprises-in-kenya-economics-essay/>

growth of SME sector only (Ardic, Mylenko and Saltane, 2011). Though it is observed that the role of SMEs is increasing significantly in respective national economies, SMEs are generally underrepresented in world trade (OECD, 2005). And measures need to be taken to make its share significant.

As noted by Mahmood (2008), role of corporate governance is also an essential factor for SMEs. For SMEs, corporate governance is all about the individual roles of the shareholders as owners and the managers. Also it is about establishing and following rules and procedures to manage and run the enterprise, setting up a system of checks and balances to stop abuses of authority and to ensure the integrity of financial statements.

### **1. 1. 2 Small and Medium Enterprises in Kenya**

The importance and contribution of SMEs to achieving macroeconomic goals of nations, especially in developing nations, has attracted the attention of scholars in the entrepreneurship discipline in recent years (Shelley, 2004). A complex global environment in which SMEs survive, grow and thrive is, therefore, considered an important objective of policy makers in both developed and emerging economies around the world. SMEs are generally known for their labour intensive activities and also for their use of local resources. Support for SMEs is a common theme because it is recognized that SMEs contribute to the national and international economic growth.

According to the MSE Baseline Survey (GoK, 1999), the sector employed 2. 4 million persons. This increased to 5. 1 million persons in 2002 as per the 2003 Economic Survey and translates to 675, 000 jobs per year. The level of employment within Micro and Small Enterprises (MSEs) in 2002 accounted

for over 74. 2% of the total number of persons engaged in the country. This is evidence that, with proper development strategies, the sector is capable of providing and surpassing the government's target of creating 500, 000 jobs per year. Small enterprise baseline survey; Central Bureau of Statistics (Central Bureau of Statistics, 2004) also indicates that there is high rate of failure and stagnation among many start-up businesses.

The survey reveals that only 38% of the businesses are expanding while 58% have not added workers. According to the survey, more enterprises are most likely to close in their first three years of operation. This is confirmed by the recent study conducted by the Institute of Development Studies (RoK, 2008) University of Nairobi which used a sample of businesses operating in Central Kenya. This study revealed that 57% of small businesses are in stagnation with only 33% of them showing some level of growth.

According to Kenya Economic Survey (RoK, 2008) , out of the total 543. 3 new jobs created in Kenya in the year 2009, Micro, Small and Medium Enterprises (MSMEs) created 426. 9 of them. This was 89. 9% of the total new jobs created in Kenya that year. In the same year, the sector contributed KSh. 806, 170 million of GDP which is 59 percent of total Gross Domestic Product (RoK, 2009). The Kenya economic survey (2010) notes that this same sector generated 390. 4 thousand new jobs which translated into 87. 6 percent of the total jobs generated in 2009. Most countries, Kenya included, cluster small and medium enterprises based on employment (Sessional Paper No. 2, 1992).

Sessional Paper No. 2 of 1992 and national baseline survey (1999), cluster enterprises in the following order; micro enterprises- 1-9 employees, small enterprises 10-49 employees; medium enterprises 50-99 employees, large enterprises -100 and above (RoK, 1992). According to the Economic Survey (RoK, 2012), the SME sector contributed 79. 8% of new jobs created in the year 2011 in Kenya. Consequently, the Kenya's development plans for the 1989-1993;, 1994-1996 and 1997-2001 periods put special emphasis on the contribution of small and medium size enterprises in the creation of employment in the country (RoK, 1989; RoK, 1994; Rok, 1999). Job creation in this sector went up by 5. 1 percent in 2011. Analysis by province shows that Nairobi County recorded a 5. 4 increase (RoK, 2012). According to the sessional paper No. 2 of (2005), SMEs have high mortality rates with most of them not surviving to see beyond their third anniversaries. This indicates that SMEs have inherent problems either in their internal environment or from the external environment that makes them fail.

## **Problem Statement**

Corporate governance is normally associated with joint stock companies that are listed on a stock exchange and/or that have a widely dispersed shareholder base. It is not often that a relationship is made between corporate governance principles and small and medium sized enterprises (SMEs).

In order to attract financing from banks and other lenders, SMEs also have to be open and transparent, must share adequate financial information and must have a professional management. SMEs can also be required by law or the bank to have a board of directors protecting the financiers. They also <https://assignbuster.com/small-and-medium-enterprises-in-kenya-economics-essay/>

may be required to give balance sheets and profit and loss statements or more sophisticated documents such as annual budgets, risk assessments or financial plans. Although the legal requirements for smaller companies differ greatly from those for larger companies, the principles related to running a business in an open and transparent manner in order to attract financing are the same for most companies.

A study shows that SMEs consistently consider access to finance a problem (Observatory of European SMEs, 2003). Although it is a basic condition to share sufficient information with banks to assess loan applications, many SMEs in the EU have problems doing so according to the study. Transparency appears to be one of the main problems. Very often smaller companies do not have the financial administrative skills, the understanding, the time or the financial means to produce the financial information required by banks. In addition, collateral requirements based on real estate or other assets cannot always be fulfilled. In addition, interest rates and bank charges are normally higher for smaller companies than for larger companies.

The governance subject has often been considered was acknowledged as a major problematic issue affecting that touches all types of enterprises particularly the SME. In fact, it is more specific to the context of small and medium size firms than that of large enterprises. In this respect, the SME specificities have to be considered separately i. e. without assimilating or interacting them with those of large-size business. As a matter of fact, the SME might apply similar governance codes to those pertaining to large businesses, yet, several elements which have a remarkable impact on affecting their structures and systems of governance must be taken into

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account (OCDE, 2006). Hence, the SME environment has recently made of this subject matter a vital issue worthy of interest. Actually, economists underline the essential role these enterprises play in creating employment, enhancing growth, innovation, exports etc. Regarding the underdeveloped countries, the SME has a paramount importance, and even more critical role as far the economy is concerned.

In fact, The SMEs have some specific characteristics distinguishing them from large enterprises namely, the strategies of planning and the survey of the practices of management (Kerr, 2006). Indeed, as regards the SME, the separation between the propriety and the decision making does not exist (Charreaux, 1998). The main managerial functions along with the capital are most frequently concentrated in the hands of the controlling owner and/ or his family (Ben Hamad, 2004).

### **1. 3 Objectives of the Study**

The study will be guided by the following specific objective:

To establish the corporate governance practices of SMEs in Kenya

#### **1. 3. 1 Specific Objectives**

The study will be guided by the following specific research objectives:

To assess the effect of transparency and shareholder relation practices on SMEs in Kenya

To investigate the effects of board of directors practices on SMEs in Kenya

To determine the effect of control environment practices on SMEs in Kenya

To assess the effect of shareholder relations practices on SMEs in Kenya

To investigate the effect of family governance practices on SMEs in Kenya

## **1. 4 Research Questions**

The study will employ the following research questions to achieve the study's objectives:

What is the effect of transparency and shareholder relation practices on SMEs in Kenya

How do board of director's practices affect SMEs in Kenya?

What is the effect of the control environment practices on SMEs in Kenya?

What is the effect of shareholder relations practices on SMEs in Kenya

How do family governance practices affect SMEs in Kenya?

## **1. 5 Significance of the Study**

The output and benefits accrued from this study will be of great importance to a number of stakeholders, including and not limited to the management of the SMEs, government of Kenya, the employees of SMEs, students studying SMEs as well as other academicians and researchers.

### **1. 5. 1 Management of SMEs**

The findings of the research would be very valuable to the management of SMEs in Kenya. The management will be able to understand how certain corporate governance practices have an influence on the general performance of the SME in terms of profitability. The research will therefore

equip the management with better information when making decisions with regard to the choice of whether or not to use specific strategies to influence their operations and profitability.

### **1. 5. 2 The Regulatory Authorities of the Republic of Kenya**

The study will aid the regulatory authorities of the republic of Kenya to be able to know the impact that corporate governance have on SMEs and the accrued benefits to the society as a whole. The corporate governance practices employed by SMEs will also have an impact on the SMEs' tax status and thus the tax authority may want to know how the choice of practices will impact on the tax levels. The study will also aid the government of Kenya when making policy decisions with regard to the SME sector of the economy.

### **1. 5. 3 Academia**

Students of Finance will be able to understand the impact of corporate governance practices on SMEs in Kenya and in similar economies in the world.

## **1. 6 Scope of the Study**

The focus of the study will be limited to the 100 SMEs selected in a survey by KPMG East Africa and Nation Media Group. The Survey seeks to identify East Africa's fastest growing medium sized companies in order to showcase business excellence and highlight some of the most successful entrepreneurship stories. The research will be conducted in the year 2013.

## **CHAPTER ONE**

### **LITERATURE REVIEW**

#### **2. 1 Introduction**

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. The specific areas covered here are corporate governance, theoretical review, empirical review and finally the conceptual framework is drawn.

#### **2. 2 Defining Small and Medium-sized Enterprises**

Small and medium-scale enterprises are defined variously. Some of the criteria employed in defining these enterprises include: number of workers, value of assets or annual turnover, nature of premises/space, status of registration/ legality of business and sustainability (CBS et al., 1999).

However, most definitions employ the number of workers criteria as this is easier to determine compared to other measures of size. For example, many businesses may not be willing to reveal the value of their assets or annual turnovers. In addition, the upper and lower limit of employees in SMEs is defined by the size of the economy (Egbetokun et al., 2010). In the United States for example, the upper limit size for SMEs is set at 500 employees for most manufacturing and mining industries (US Small Business Administration, 2009). In the European Union, a medium enterprise is one that employs up to 250 people (Commission Recommendation, 2003). In China, the definition of SMEs is quite complex and can include relatively large firms. For example, an industrial SME is defined as having up to 2, 000 employees, while a medium-sized business has between 301 and 2, 000 employees, and a small business has less than 300 workers (www. eria.

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org/research/images/pdf/china-pdf). Therefore, what is regarded as an SME in China or in the US maybe quite large relative to an SME in another smaller economy.

In Kenya, there are different definitions of SMEs which are yet to be consolidated. For example, a national baseline survey of MSEs carried out in 1999 defines a small enterprise as one which employs 6-10 people while a medium one is expected to have 11-100 employees (CBS et al, 1999). However, there is an MSE bill that has been in process for 10 years, but has not yet been enacted into law. This bill takes a different approach by combining employment with other measures of size. For example, it defines a micro enterprise as a business activity whose annual turnover does not exceed Ksh. 500, 000 and/or employs less than 10 people with total assets and financial investment subject to determination by the Minister from time to time.

Table 2. Categorization of MSMEs based on number of workers

## **Firm size**

### **No. of Workers**

Micro enterprise

1-9

Small enterprise

10-49

Medium enterprise

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50-150

## **Source: Author's own conceptualization**

### **2.3 Definition of Corporate Governance**

Jensen and Meckling (1976) developed a theory of the ownership structure of a firm. The basis for their analysis was the perspective that a corporation is: 'a legal fiction which serves as a nexus for contracting relationships and which is also characterised by the existence of divisible residual claims on the assets and cash-flows of the organization which can generally be sold without the permission of the other contracting individuals' (Jensen and Meckling, 1976, p. 61).

The central point in corporate governance of the firm was laid out by Berle and Means (1932). They observed that a consequence of the separation of ownership and management was ownership dispersion and that such dispersion made subsequent monitoring and discipline of management difficult.

More recently Demb and Neubauer (1992) described corporate governance as the process by which corporations are made responsive to the rights and wishes of stakeholders. Monks and Minow (1996) defined corporate governance as the relationship among various participants in determining the direction and performance of corporations. Neubauer and Lank (1998) defined corporate governance as a system of structure and processes to direct and control corporations and to account for them.

Corporate governance describes all the influences affecting the institutional processes, including those for appointing the controllers and regulators, involved in organising the production and sale of goods and services (Turnbull, 1997). Sir Adrian Cadbury stated that corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals (Iskander and Chamlou, 2000). The Asian Development Bank (ADB) defined corporate governance as the manner in which power is exercised in the management of a country's social and economic resources for development (Wescott, 2000).

Iskander and Chamlou (2000) stated that corporate governance is important not only to attract long-term patient foreign capital, but more especially to broaden and deepen local capital markets by attracting local investors- individual and institutional. Nielsen (2000) stated that corporate governance is the system of rights, structures and control mechanisms established internally and externally over the management of a listed public limited liability company, with the objective of protecting the interests of the various stakeholders. Kidd and Richter (2003) argued that corporate governance is an indirect mechanism in reducing agency costs and transaction costs imposed by managers acting in their own interests at the expense of companies and shareholders. Solomon and Solomon (2004) suggested that corporate governance is the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.

The Organisation for Economic Co-operation and Development (OECD) defined corporate governance as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs (Clarke, 2004).

## **2. 4 Corporate Governance around the World**

The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionised business laws and practices in England. In the United States of America (USA) there was the stock market crash of 1929. There were other crises, such as the secondary banking crisis of the 1970s in the United Kingdom (UK) and the USA savings and loan debacle of the 1980s. In addition to crises, the history of corporate governance has also been punctuated by a series of well-known company failures: the Maxwell Group of newspapers; the collapse of the Bank of Credit and Commerce International; and Barings Bank. As a result, regulators have moved to improve the elements of corporate governance (Iskander and Chamlou, 2000).

In the early 1990s, research on corporate governance in countries other than the USA began to appear. At first, the research focused on other major world economies, primarily Japan, Germany, and the UK (Denis and McConnell, 2002).



## **2. 4. 1 United States of America**

In 1929, the Wall Street stock market crash occurred in the USA. The stock market collapse revealed market manipulation, insider trading, general mismanagement and a reckless trampling of shareholder rights. As a result, the USA Congress enacted the Securities Act 1933 and the Securities and Exchange Act 1934 to address some of these abuses, primarily through the regulation of corporate financial disclosure to improve transparency.

In the late 1980s, the response to governance failure in the USA was similar to the response noted in the 1930s. The most recent round of reforms began as a result of takeovers and constituency statutes enacted under state laws. The major performance problems became evident in many of the largest corporations; reform began to focus more on the quality of corporate boards and their independence. An active group of institutional investors began to emerge and grow (Iskander and Chamlou, 2000).

In the USA in 2001, corporate crises occurred at Enron, WorldCom, Tyco International, Adelphia Communications, Global Crossing, Quest Communications, Computer Associates, and Arthur Andersen. The collapse of Enron, the largest bankruptcy in USA history, led to thousands of employees losing their life savings tied up in the energy company's stock. This proved to be an unprecedented display of accounting fraud, regulatory failure, executive excess and avoidable bankruptcy, with resulting widespread disastrous losses incurred by employees' pension funds and investors. As a result, the USA Congress enacted the Sarbanes-Oxley Act (2002). This is a broad-based reform act centred on the creation of a public company

accounting oversight board and the establishment of strict rules regarding  
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auditor independence, corporate responsibility, financial disclosures, financial controls, analyst conflict of interest, white collar crime and corporate fraud (Banks, 2004).

Kiel et al., (2004) stated that the USA attempted to achieve good governance. They established the Report of the NYSE Corporate Accountability and Listing Standards Committee, and the Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy; the Sarbanes-Oxley Act of 2002 was also introduced. This Act contains significant black letter law aimed at curbing some of the perceived worst abuses in corporate governance. The Sarbanes-Oxley Act of 2002 was a compromise bill, supported by Republicans and Democrats, designed to strengthen the criminal consequences for top management in cases of misrepresentation of financial results. In addition to requiring the chief executive to sign the audited statements of the company, the law strengthens the power of auditing committees and the regulatory oversight of auditing firms (Cornelius and Kogut, 2003).

Denis and McConnell (2002) suggested that the ownership of publicly traded firms is significantly more concentrated in other countries than it is in the USA. Private ownership concentration appears to have a positive effect on firm value. There are significant private benefits of control and they are more significant in most other countries than they are for the USA. Structures that allow for control rights in excess of cash flow rights are common, and generally value-reducing.

Solomon and Solomon's (2004) study of the case of Enron's downfall illustrates the importance of good corporate governance. They say that all the checks and balances within the corporate governance system have the ultimate aim of controlling and monitoring company management. Corporate governance mechanisms cannot prevent unethical activity by top management, but they can act as a means of detecting such activity.

Boards of directors in the USA include some of the very insiders who are to be monitored. In addition, it is not uncommon that the Chief Executive Officer (CEO) is also the chairperson of the board. The nature of the selection process for board members is such that management often has a strong hand in determining who the other members will be. Board composition characteristics of interest include the size and structure of the board, the number of directors that comprise the board, the portion of these directors that are outsiders, and whether the same individual holds the CEO and chairperson positions (Denis and McConnell, 2002).

Holderness (2002) studied the USA evidence on equity ownership by insiders and block-holders, where insiders are defined as the officers and directors of a firm and a block-holder is an entity that owns at least 5 percent of the firm's equity. He reported that average inside ownership in publicly traded USA corporations is approximately 20 percent varying from almost none in some firms to majority ownership by insiders in others.