Board of directors and small medium enterprise’s firm growth with firm culture as moderating factor in Malaysia

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Abstract

This conceptual paper is based on a study that explores differences of board of directors’ attributes and SMEs firm growth based on firm culture types in Malaysia. The objectives are to explore a model for overall SMEs firm growth based on board of directors’ attributes, to examine the relationship between board entrepreneurial and guanxi in relations with SMEs firm growth. This paper also aims to identify differences of board of directors’ attributes and SMEs firm growth based on firm culture types. One of the most significant theoretical implications is the introduction of a conceptual model on SMEs firm growth, board of directors’ attributes and firm culture based on Malaysia context. From the practitioners’ perspectives, this paper suggests improvement of existing approaches to the governance of SMEs.

Keywords: SMEs firm growth; firm performance; board of directors; firm culture

1. Introduction

When it comes to understanding small and medium enterprises’ (SMEs) growth and corporate governance, little is known about growth as the performance indicator. Across the board of directors in corporate governance and firm performance literature, financial performance measurements such as return on equity (ROE) and return on assets (ROA) are widely used in the previous studies (Callahan, Millar, & Schulman, 2003; Haron, Ibrahim, &

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Muhammad, 2008; Rahman & Haniffa, 2005). This conceptual paper fills the research gap to examine board of directors’ attributes and SMEs’ firm growth based on measurement of sales growth, employment growth, introduction of new products or services and venturing into new geography market. We include the concept of “newness” or exploration of new ventures, either in the form of offerings or markets due to the growing concerns in SMEs studies on innovation (Lofstén & Linderlof, 2002; Naldi & Davidsson, 2013; Terzirovski, 2010). Prior studies on SMEs have also ignored an investigation of the firm culture on the relationship between boards of directors’ and firm performance. This is a theoretical lapse with the boundary of SMEs studies as most organizational growth studies promote the linkage between firms’ culture and performance (Dwyer, Richard, & Chadwick, 2003; Pelham & Wilson, 1996). Thus, the inclusion of the firm culture variables would be meaningful to explain differences in perceptions based on the respondents’ firm culture SMEs are the central subject or unit of analysis in this study due to its critical existence in growth of nations. SMEs accounted for 97.3 percent from the total company establishments in Malaysia (SMECorp Malaysia, 2012). In other word, the total number of SMEs firms in Malaysia constituted of 645,136 companies compared to the large firms of 17,803 companies only (SMECorp Malaysia, 2012). A more recent statistics revealed that Malaysia’s SMEs contribute 32.5 percent in Gross Domestic Product (SMECorp Malaysia, 2012). In terms of employment growth and labor productivity growth, the SMEs growth is also higher than the overall nation employment and productivity growth (SMECorp Malaysia, 2012). Hence, the contribution of SMEs is vital for Malaysia to achieve as a high income nation by year 2020.

The negative impacts of illegal and unethical corporate practices have provided the public to re-look the changing roles, responsibilities, and expectations on board of directors’ in corporate governance issues. Although, most of corporate governance scandals relate to big corporations, an increasing attention from the investing public on corporate governance in small and medium enterprises (SMEs) are on the rise (Coulson-Thomas, 2007). However, most of the previous studies on corporate governance and firm performance focused on developed nations (Core, Holthausen, & Larcker, 1999; Kalyta, 2009; Kor & Sundaramurthy, 2009). Few studies on this topic were conducted in developing countries including Malaysia. Nevertheless, few studies which were conducted in Malaysia focused on some large firms listed on Malaysian Stock Exchange or Bursa Malaysia only (Abdullah, 2006; Haron et al., 2008; Rahman & Haniffa, 2005). Furthermore, the data of these previous studies were derived from secondary data based on the annual reports of the Bursa Malaysia. The studies to examine on the relationship of board of directors’ variables and SMEs firm growth using survey research method to collect primary data in Malaysia context is scarce.

There is a dearth of exploratory endeavors in the context of SMEs firm growth and board of directors’ attributes for developing nations. Thus, empirical study in this area merits critical attention. We attempt to explore a model for overall SMEs firm growth based on board of directors’ attributes. We aspire to examine the relationship between board entrepreneurial orientations, board guanxi, and SMEs firm growth in Malaysia context. Another equally important objective of this paper is to identify differences of board of directors’ attributes on SMEs firm growth based on firm culture types. The next section discuss the relevant literature on the concepts of SME firm growth, board of directors’ in corporate governance and firm culture. We dedicate a section for appropriate methodologies used and expected findings before presenting the conclusion.

2. SMEs firm growth

Although a considerable amount of researches have been conducted on firm growth, a solid single integrative theory or model to explain firm growth has yet to emerge. From Penrose (1959) perspective, firm growth concerns 1) an increase of amount in terms of the firm output, sales, and export volume; 2) can be an increase in firm size as a result of process development. Hence, in reference to this early work, growth can be measured with a broad range of proxies, such as sales, employment, assets, physical output, market share, and profits (Ardishvili, Cardozo, & Vadakath, 1998; Delmar, 1997; Wiklund, 1998). Regardless of the variation in definition, there is a general consensus to use sales and employment as the preferred indicators in measuring firm growth (Aaboena, Lindelof, Kochc, & Lofsten, 2006; Ardishvili et al., 1998; Wiklund & Shepherd, 2005).

From the stochastic model point of view, firm growth rate is independent of firm size and prior growth rate.
In other words, firm growth is not associated with the firm size and the past growth rate of the firm. Consequently, a small firm might grow at the same rate or faster than the large firm. The stochastic model also known as Gibrat’s Law revealed that firm growth is the result of multiplicative growth process that affects the initial firm size. No single factor, but numerous factors may affect the firm growth rate including environment factors (Sutton, 1997).

According to the stage growth model, the firm growth is a phenomenon that happens over time (Hanks, Watson, Jansen, & Chandler, 1993). In other words, firm growth must be studied with longitudinal method so that at least in the sense that assessment of the predictors precedes assessment of the outcome. This is in consistent with Penrose (1959) notion that firm growth also occurs with the change in firm size. The stages growth model assumed that a firm grows and develops through various stages of growth comprising of firm start-up stage, expansion stage, growth stage, maturity stages, and decline stage (Churchill & Lewis, 1983; Greiner, 1972; Hanks et al., 1993).

However, from the perspective of factor approach model, firm growth is affected by a set of internal and external factors, particular in the patterns of causes and effects (Marris & Mueller, 1980). A broad range of firm growth earlier studies using factor approach model has focused on different factors such as firm age and firm size (Storey, 1994; Sutton, 1997). Moreover, Davidsson, Kirchhoff, Hatemi-j, and Gustavsson (2002) revealed a positive correlation between firm growth and firm location. In a more recent work, Davidsson, Steffens, and Fitzsimmons (2009) explore consequences of firm growth associated with high and low profitability via resource-based theory. Based on an extensive review of literature of small firm or SMEs firm, Wiklund (1998) develops a theoretical model that comprises of four attributes comprising of 1) environment; 2) resources; 3) motivation, and 4) strategy of entrepreneur firms. The model of Wiklund (1998) demonstrated the effects of attitudes, resources and capabilities, industry, and perceived environment on firm growth or firm performance mediated through entrepreneurial orientation (EO).

In a similar vein, Davidsson (2005) presented that the growth of small firm or SMEs through the launch of new products or services as well as expansion into new geographic markets either locally or internationally is crucial. In line with these specific forms of growth, Naldi and Davidsson (2013) using data of 138 small and medium-sized enterprises (SMEs) to examine the acquisition of knowledge in relation with growth through market development and introduction of new products or services. The study found a positive effect on growth via new products or services development in young firms, but a negative effect in mature firms.

The application of financial performance indicators such as return on equity (ROE) and return on asset (ROA) are widely used in the previous studies on the relationship between board of directors’ and firm performance (Awan, 2012; Rahman & Haniffa, 2005; Yusoff & Alhaji, 2012). Prior studies provide a gap to examine the relationship between the boards of directors and firm growth as an indicator. Growth as a performance indicator is more accurate and accessible than accounting or financial indicators (Wiklund & Shepherd, 2005).

3. Board of directors in corporate governance

A general definition of corporate governance is that corporate governance is a system by which firms are directed and controlled (Broni & Velentzas, 2012). To this end, corporate governance is focused to the control over the allocation of firm resources (O’Sullivan, 2000). From a finance perspective, corporate governance is regarded as the ways in which suppliers of finance guarantee of getting back a return on their investment (Shleifer & Vishny, 1997). However, from a legal point of view, corporate governance is defined as the legal and factual system by which firms are directed and controlled (Grundei & Talaulicar, 2002). Nevertheless, scholars on this topic generally refer corporate governance as the relationships among the company management, board of directors, shareholders, and other stakeholders (Aoki, 2000; Huse, 2005; Johnson & Greening, 1999; Monks & Minow, 1995).

Jensen and Meckling (1976) proposed the agency theory by the existence of agency cost due to the separation of ownership and control in the corporation or firm. The suggestion of Jensen and Meckling (1976) is in consistent
with Berle and Means (1932) proposition which explained that the conflict of interest between principals and agents is the main issue in agency theory. Agency theory emphasized that a principal (shareholder) assigns the decision making power of a firm to an agent (manager) to execute their duties on behalf of the principal (Jensen & Meckling, 1976). In such a situation, the board of directors is regarded as a crucial mechanism to moderate and to reduce the conflicts between the principal and agent (Fama & Jensen, 1983).

Although the control role is the most common role demonstrated in the governance of the boards of the directors with regard to agency theory, there are other roles equally important played by the board of directors. For example, Zahra and Pearce (1989) identified three major roles played by the boards, namely control, strategy, and service roles. The boards’ control role consists of monitoring and rewarding managers. From the view point of stewardship theory, the strategy role of the boards is to formulate and implement firms’ goals and policies. In line with the resource dependency theory, the service role is associated to linking the firm with its external environment to obtain critical resources. In the similar vein, Hung (1998) revealed that board of directors’ roles is a complex phenomenon and there is no particular theoretical perspectives can be completely explained the entire involvement of the boards of directors. In the context of SMEs, board of directors is supposed to play multiple roles (Gabrielsson & Winlund, 2000; Huse, 1990; Huse, 2005).

Numerous studies in corporate governance relate the boards of directors’ and firm performance discussed the issues of board Independence, board Ownership, board Size and CEO duality (Fauzi & Locke, 2012; Firth, Fung, & Rui, 2007; Pearce & Zahra, 1992; Seifert, Gonenc, & Wright, 2005). This conceptual paper reexamines board independency, board Ownership, CEO duality and explores board entrepreneurial orientations (EO) and board network (board guanxi) in SME firms. The SMEs boards’ role is not limited to the control role as proposed by the agency theory applicable to the large firms. However, SMEs boards’ also perform the service and strategic role (Gabrielsson & Huse; 2002; Gabrielsson, & Winlund, 2000; Huse, 1990; Johannisson & Huse, 2000). Thus, the inclusion of board guanxi and board entrepreneurship is vital in this paper.

3.1 Board independency

Board independence refers to the proportions of outside and inside directors on the board of directors (Kor & Sundaramurthy, 2009). Independent directors are also known as non-executive directors or outside directors. From agency perspective, the existence of independent directors representing a tool of monitoring the actions of the executive directors in particular and ensuring that entire board of directors and management in general to follow firm policies and strategies in consistent with shareholders’ interests (Fama, 1980). The presence of independent directors is expected to improve firm performance (Brown & Caylor, 2004; Daily & Dalton, 1993; Pearce & Zahra, 1992). Black, Jang, and Kim, (2006) also report that Korean firms with 50% outside directors have 0.13 higher Tobin’s Q or approximately forty percent higher on share price. A hypothesis is derived from the above arguments as follow;

Hypothesis 1: Board independency is correlated with SMEs firm growth.

3.2 Board ownership

An early study conducted by Berle and Means (1932) found an increasing conflict of interest between firm managers and shareholders when managers without ownership interest in the firm. From the agency theory perspective, the interest conflicts between shareholders and managers would reduce as the managers’ ownership increase (Jensen & Meckling, 1976). Managerial ownership in this context refers to director ownership, CEO ownership and manager ownership. The central focus of present study is based on director ownership. This is consistent with the study of Seifert et al. (2005) which found that BOD in SMEs ownership proportion can cause the agency costs to go down, hence increase firm performance. However, a close ownership-management relationships are appeared to most SMEs across the countries. Furthermore, accountability to owners and empowerment of managers are combined in the SMEs organizational structure. The ownership-management function can be considered as an another advantage in the governance of SMEs which can eliminate the agency cost as in many big firms and allow SMEs to make fast decision in rapid changing business environment (Coulson-Thomas, 2007).
Hypothesis 2: Board ownership associated with SMEs firm growth.

3.3 CEO duality

Another board of directors’ characteristics, the CEO duality refers to the same person takes the positions as CEO and chairman of the board at the same time in a firm. An earlier study demonstrated that the separation between CEO and chairman positions can improve the effectiveness in monitoring the management team and increase firm performance (Jensen & Meckling, 1976). Conversely, many other studies found the CEO duality has a positive effect on firm performance under certain circumstances. For instance, Yang and Zhao (2012) revealed that firms with CEO duality outperform the firms without CEO duality. Moreover, the study has uncovered the advantages of CEO duality in saving information costs and making speedy decisions (Yang & Zhao, 2012). Nonetheless, the research of CEO duality in SMEs context is very rare in corporate governance literature.

Hypothesis 3: CEO duality has a relationship with SMEs firm growth.

3.4 Board guanxi

Besides the approach of interlocking directorships, board network may be investigated from another point of view, namely guanxi approach. An interlocking directorship is when one director who sits on multiple boards of firms, and it is one kind of board network which creates an important links among firms. Filling a gap in the interlocks literature which were largely centered on the developed countries (Hung, 1998; Pfeffer & Salancik, 1978; Zahra & Pearce, 1989). However, this present study introduces the board guanxi as a dimension to better understanding the board network in the Malaysia SMEs context. According to Tsang (1998), Guanxi can be defined as personal connection, close and good relationships, as well as one’s social network. In addition, guanxi is crucial to long-term personal relationships and plays a vital role in the Chinese daily social and business life (Tsang, 1998). However, this present study introduces the board guanxi as a dimension to better understanding the board network in the Malaysia SMEs context. According to Tsang (1998), Guanxi can be defined as personal connection, close and good relationships, as well as one’s social network. In addition, guanxi is crucial to long-term personal relationships and plays a vital role in the Chinese daily social and business life (Standifird & Marshall, 2000). Hwang (1987) also presented that Mianzi (face) is a form of social capital in Chinese business community which involves the amount of the actual and potential resources of membership in a particular social networks. Chinese always say that "giving face," or "losing face," between personal level and among organizations level. This situation proved that Mianzi or face maintenance is an important factor for Chinese people social interactions and businesses transactions (Hwang, 1987). In addition, Lee, Pae, and Wong (2001) revealed that guanxi positively affects business performance. The previous studies on guanxi are focused on the investigation of the Chinese’s enterprises, but the present study covers broader parameters to include the non-Chinese enterprises.

Hypothesis 4: Board guanxi positively affects SMEs firm growth.

3.5 Board Entrepreneurial Orientation

Several empirical studies support for entrepreneurial orientations (EO) has a positive impact on firm performance (Wiklund, 1999; Zahra 1991; Zahra & Covin, 1995). The initial conceptualization of three EO dimensions were suggested by Miller (1983) which has only three dimensions, namely 1) innovativeness, 2) risk taking, and 3) proactiveness. However, two additional dimensions of EO were proposed by Lumpkin and Dess (1996) comprising of 1) competitive aggressiveness and 2) autonomy. Most of studies in entrepreneurial literature used the Miller (1983) definition as a tool to operationalize entrepreneurial firm with three dimensions of EO only (Wiklund, 1999; Wiklund & Shepherd, 2003; Zahra & Covin, 1995). In the study of EO in Malaysia SMEs context, Omar and Rejab (2011) revealed that many Malaysian SMEs entrepreneurs in information communication technology (ICT) have steered their organizations from humble start-ups to professional ventures. Nevertheless, the availability of empirical investigations on EO in SMEs board is still limited. This paper aims to investigate the relationship between SMEs board EO and firm growth in Malaysia SMEs context.
Hypothesis 5: Board Entrepreneurial Orientations positively associated with SMEs firm growth.

4. Firm culture

Firm culture refers to the shared philosophy, norms, values, beliefs and attitudes which influences an organizational behavior (Kilmann, 1985). In other words, it means that a common perceptions which are practiced by the members of a firm. Deshpande and Webster (1989) proposed that firm culture is the pattern of shared values and beliefs that help individuals understand how a firm functioning and a norms to behave in the firm. Firm culture could be a strategic asset for the organization to enhance the adaptability to fit into its environment (Kotter & Heskett, 1992).

The competing values model has become a popular and validated framework for studying organizational cultures, and a tool for organizational analysis (Cameron & Quinn, 1999; Deshpande et al., 1993). This framework refers to whether an organization has a tendency of internal or external focus, whether it concerns for flexibility and individuality or stability and control. The framework comprises four culture types, namely Clan, Adhocracy, Market, and Hierarchy (Cameron & Quinn, 1999). Teamwork, cohesiveness, and participation are the keys of clan culture. Adhocracy culture focuses on entrepreneurship, flexibility, and creativity. On the other hand, customer focus, goal achievement, and productivity are highly valued in market culture. However, hierarchy culture concerns about order, stability, and formalized rules.

Numerous studies on firm culture or corporate culture are conducted in connection with organizational effectiveness. For instance, an earlier study conducted by Steers (1975) proposed that the measurement of effectiveness is the most discussed issue in the organizational culture literature. On another study, Ouchi (1980) has identified the characteristics to determine the organizational effectiveness in relation with firm culture. In the similar vein, Ostroff and Schmitt (1993) found that the organizational effectiveness has a positive relation with the organizational culture. Consequently, organizational culture is found to have strong relationship with business organizational effectiveness (Juechter, Fisher, & Alford, 1998). Although numerous studies have been conducted to explore the relationship between organizational culture and performance, empirical findings seem to be mixed and inconclusive (Detert, Schroeder, & Mauriel, 2000; Hartnell, Ou, & Kinicki, 2011). In an effort to resolve these inconsistencies, this present study suggests that the relationship between boards of directors and SMEs firm growth is subject to firm culture conditions.

Hypothesis 6: There are differences in SMEs firm growth based on firm culture types.

5. Conceptual framework and conclusion

Based on the thread of discussion, we develop a conceptual model (Fig. 1) that proposes relationships between SMEs’ firm growth, board of directors’ attributes, and firm culture.

![Conceptual framework](image)

We foresee that a difference in mean score of SMEs firm growth based on firm culture types. We also expect a positive correlation between board entrepreneurial orientations, board Guanxi, and SMEs firm growth. The board
of directors’ attributes assumed to be significantly explained the variance in SMEs firm growth. This would help the understanding of SME firm growth and corporate governance in Malaysia SMEs context. This study will apply the concept of triangulation, as we intend to combine quantitative and qualitative approaches. Hopefully by applying triangulation, we could maximize the advantages and minimize the disadvantages connected to either methodology is adopted. While a longitudinal study may generate much in-depth understanding of the phenomena, we foresee employing a cross-sectional approach to examine the relationships among the variables due to consideration on the time, financial, and effort required. This empirical study would involve a series of research activities such as interview with the owner-managers of SMEs to obtain the prior subject knowledge for the study. The quantitative stage would encompass the distribution of a survey questionnaire to owners and board of directors across the country. One of the most significant theoretical implications may be the introduction of a conceptual model on SMEs firm growth, board of directors’ attributes, and firm culture based on Malaysia context. It is also interesting to know whether the “Guanxi” elements has permeated Malaysian non-Chinese enterprises, as well as understanding its processes and implications. This paper also initiates the need to consider the measurement of SMEs firm growth based on sales, employment, new product, and new market as performance indicators. Regarding the managerial implication, this paper provides some opportunities for the improvement of existing approaches to the governance of SMEs. Thus, this preliminary conceptual work actually opens door for further empirical work to consider the effects of board EO, board guanxi, and the firm culture toward SME’s governance and growth.

References


