

Corporate Governance Reform Team  
Department for Business, Energy & Industrial Strategy  
3rd Floor Spur 1  
1 Victoria Street  
London  
SW1H 0ET

17<sup>th</sup> February 2017

Dear Secretary of State,

## **CORPORATE GOVERNANCE REFORM: GREEN PAPER**

FSB welcomes the opportunity to respond to the above consultation.

FSB is the UK's leading business organisation. Established over 40 years ago to help our members succeed in business, we are a non-profit making and non-party political organisation that's led by our members, for our members.

Our mission is to help smaller businesses achieve their ambitions. As experts in business, we offer our members a wide range of vital business services, including advice, financial expertise, support and a powerful voice in government.

FSB is also the UK's leading business campaigner, focused on delivering change which supports smaller businesses to grow and succeed. Our lobbying arm starts with the work of our team in Westminster which focuses on UK and English policy issues. Further to this, our expert teams in Glasgow, Cardiff and Belfast work with governments, elected members and decision-makers in Scotland, Wales and Northern Ireland.

Yours sincerely,



Martin McTague

Policy Director  
Federation of Small Businesses

# **FSB response to Corporate Governance Reform: Green Paper**

**February 2017**

## CORPORATE GOVERNANCE REFORM: GREEN PAPER

The Federation of Small Businesses (FSB) welcomes the opportunity to respond to the Green Paper on Corporate Governance reform on behalf of its members across the UK.

### Introduction

Corporate governance is:

*'...the system by which business[es]...are directed and controlled. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performances are determined'.<sup>1</sup>*

Smaller businesses have two key interests in the corporate governance debate:

- **Fair supply-chain practice.** Smaller businesses are key supply-chain stakeholders for larger companies. In supply-chains smaller and larger companies are involved in mutually beneficial commercial relationships. Nurturing of the supply-chain through effective management has a number of benefits which accrue not just to the larger end-customer enterprise but along the whole supply-chain.<sup>2</sup> Corporate governance has a central role in making sure that the benefits from effective supply-chain management are realised.<sup>3</sup> While some businesses are very good at managing their supply-chain and benefit from the advantages that good supply chain practices bring with them, too many companies in the UK are failing to nurture their supply-chains through the employment of poor supply-chain practices, such as late payment. These are detrimental to the smaller businesses in those supply-chains, the larger end-customer businesses themselves and the wider prosperity of the economy. Additionally, typically with more employees in the supply-chain of a large business compared to the numbers directly employed by an individual large business measures which improved supply-chain practices would benefit millions in the UK's workforce.
- **Good small business governance.** There are 1.8 million trading companies in the UK.<sup>4</sup> Many of which are small businesses. Consequently, an effective framework for the governance of smaller businesses i.e. a company law regime that allows small businesses to access the benefits of limited liability and supports their growth and success, is an essential ingredient in the success of these individual businesses and the dynamism of the wider small business community.<sup>5</sup> Governance of smaller firms is just as important as

<sup>1</sup> OECD. 'White Paper of Corporate Governance in South Eastern Europe'. (2003) cited in Bundaleska, E., Dimitrova, M and Nikolovska, Z. 'Corporate governance and small & medium sized enterprises'. (2011).

<sup>2</sup> Li, S et al. 'The impact of supply-chain management practices on competitive advantage and organizational performance'. (2004).

<sup>3</sup> Glatzel, C. and Rohren, J. 'Supply-chain management on the CEO agenda' in 'Excellence in supply-chain management', eds: Glatzel, C. and Niemeyer, A. (2014).

<sup>4</sup> ONS/ BEIS. 'Business Population Estimates for the UK and Regions 2016'. (2016).

<sup>5</sup> There are over 3 million registered companies at Companies House. Source: Companies House. 'About Us'. (2017). Available at: <https://www.gov.uk/government/organisations/companies-house/about#what-we-do>

it is for other businesses because small businesses want to obtain their objectives just as much as any larger business does.<sup>6</sup> Good governance delivers a number of real benefits for smaller businesses. It can:<sup>7</sup>

- Reduce the risk of conflict between owners, especially those who are not actively involved with management and those that are.
- Enhance access to credit and other sources of investment especially equity finance, which higher growth businesses find most beneficial.<sup>8</sup>
- Increase resilience to fraud, theft or other financial costs.
- Help enlarge access to a range of expertise and business networks that might not otherwise be available.<sup>9</sup>
- Support and enable effective business leadership, planning, management and growth.

Therefore FSB considers that small business governance should not be forgotten in the debate over corporate governance.<sup>10</sup> Rather it should be a part of the discussion. Not least because, while the overall framework of company law in the UK works well for smaller firms, there is room for further improvement.

This submission is divided into two parts, each outlining FSB's views on the both key areas of interest for small businesses in the debate over the corporate governance framework:

- The first section describes the importance of more explicit recognition, at the highest level of larger business, of the importance of the supply-chain and the role of small businesses within them. The current failure to prioritise supply-chain relationships through good supply-chain payment practices in particular has a range of damaging consequences for small businesses, the larger business at the apex of the supply-chain as well as the wider economy.
- The second looks at the complex issue of governance in small businesses and how that complexity and the current company law framework interact. It further explores the extent to which further tweaking to the existing regime might further improve the framework for small businesses and help contribute to more economic benefits.

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<sup>6</sup> ACCA. 'Governance for all: the implementation challenge for SMEs'. (2014).

<sup>7</sup> ACCA. 'Governance for all: the implementation challenge for SMEs'. (2014).

<sup>8</sup> The Breedon Review noted that equity finance can potentially benefit businesses in the early stages of their development, by getting the right framework to stimulate investor appetite for equity and thereby lowering the cost of raising such capital.

Source: Breedon CBE, T. 'Boosting finance options for business'. (2012).

<sup>9</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>10</sup> The term 'corporate' in the 'corporate governance' debate is a proxy for 'large'. . In larger businesses effective corporate governance is primarily required to overcome principal-agent problems i.e. to control risks associated with managerial discretion when ownership is dispersed among disparate groups of shareholders. However, the use of the term 'corporate' should not just be used as a proxy for 'large'. It should be used to capture the governance of all corporate enterprises.

## Corporate governance and supply-chain payment practices

### The supply-chain problem that needs to be tackled

Small businesses play a significant role in the UK economy. They make up nearly all of the UK's 5.5 million strong business population and employ nearly half of the private sector work force.

**Table 1: UK economy: the contribution of small business<sup>11</sup>**

	Proportion of the total business population	Proportion of total private sector employment	Proportion of total private sector turnover
Small and medium-sized business	99.9%	60%	47%
Small business	99.3%	48%	33%

Small businesses generate the majority of new jobs in the economy and are a key driver of competition in markets making sure they are dynamic and efficient.<sup>12</sup> Therefore a prosperous small business community is vital for a growing UK. Many small businesses contribute to the success of the economy through their participation in supply-chains.<sup>13</sup> Consequently, thriving supply-chains are a key factor underpinning a healthy small business sector, the competitive advantage of larger businesses and a prosperous wider UK economy:

*'...today's competition is moving from 'among organizations' to 'between supply chains'...SCM [supply chain management] practices can have discernible impact on competitive advantage and organizational performance'.<sup>14</sup>*

However, many supply-chains are not effectively managed and the additional competitiveness that can be obtained through high quality supply-chain management is often lost as a result. The evidence for prevalence of poor supply-chain practices can be found in the proportion of small businesses that experience late payment or are on the end of other detrimental

<sup>11</sup> ONS/ BEIS. 'Business Population Estimates for the UK and Regions 2016'. (2016).

<sup>12</sup> 67 per cent of new jobs generated between 1998 and 2010 were created by small businesses. Source: BIS (2013). 'SMEs: the Key Enablers of Business Success and the Economic Rationale for Government Intervention'.

<sup>13</sup> The Small Business Survey (SBS) asks SMEs who their main customers are. Among the SME population as a whole, 38 per cent identified other businesses as their main customer. This is a lower bound as it only captures businesses who consider other businesses to be their main customer and so does not count businesses that mainly supply consumers but also supply some businesses. These businesses in turn may or may not be exporters. Source: BIS. 'BIS Estimate of the Proportion of UK SMEs in the Supply Chain of Exporters'. (2016). Available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/524847/bis-16-230-smes-supply-chains-exporters.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524847/bis-16-230-smes-supply-chains-exporters.pdf)

Research by OCR international asked SMEs whether they considered themselves to be part of a supply chain. 77 per cent of respondents considered themselves to be so. Source: Jamieson, D Fettiplace, S York, C and Lambourne, E. 'Large Businesses and SMEs: Exploring how SMEs interact with large businesses'. (2012). Available at:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/34639/12-1196-exploring-how-smes-interact-with-large-businesses.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/34639/12-1196-exploring-how-smes-interact-with-large-businesses.pdf)

<sup>14</sup> Li, S et al. 'The impact of supply-chain management practices on competitive advantage and organizational performance'. (2004).

supply-chain practices such as bullying.<sup>15</sup> The most visible aspect of supply-chain management failure is that of poor payment practices:<sup>16</sup>

- On average, 30 per cent of payments are typically late, which is an increase from 2011 (28%) – suggesting the pervasiveness of late payments has worsened in recent years.
- Large private businesses are the most likely to pay small businesses late. FSB research found that over three fifths (61%) of payments from large private firms tended to be late.
- The average amount owed in late payment to a small business is £6,142.

Beyond poor payment practice there is an ingrained culture of supply-chain bullying across large parts of the UK supply-chain landscape. With almost one in five (17%) FSB members reporting that they had experienced such bullying between 2012 and 2014.<sup>17</sup>

This failure in many UK supply-chains and that is evident in FSB data has been acknowledged by some large companies and business organisations. For example, the Financial Reporting Council noted in a July 2016 report that:

*‘...a challenge for companies is how to ensure that supplier culture and behaviour meet the standards that apply within their own group’.*<sup>18</sup>

The picture painted above illustrates the importance of providing a stronger voice for those businesses in supply chains. As a result of a large proportion of the UK’s near 5.5 million small businesses being involved in a supply chain in one form or another, representation of their interests are simultaneously representative of the interests of the millions of employees of those supply-chain businesses. Therefore strengthening the voice of suppliers is an integral component of achieving better representation of these additional stakeholder interests too, as well as generating the wider benefits (as described) that come with improving the UK’s business culture.

### **The specific impacts of poor supply-chain practices on small businesses and the economy**

The consequences of such detrimental supply-chain practices, for small businesses, bigger companies and the economy, have been highlighted by FSB in the recent report: *‘Time to Act: The Economic Impact of Poor Payment Practice’*. The analysis in this report found that such supply-chain practices have material impacts on:

- The size of the small business population.

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<sup>15</sup> FSB. ‘Time to Act: The Economic Impact of Poor Payment Practice’. (2016).

<sup>16</sup> FSB. ‘Time to Act: The Economic Impact of Poor Payment Practice’. (2016).

<sup>17</sup> A survey of 2,500 FSB members in December 2014, almost one in five (17%) said they had faced supply chain bullying in one form or another in the previous two years. FSB, ‘Supply chain bullying affects almost one in five small businesses’. (2014). Available at: <http://www.fsb.org.uk/media-centre/press-releases/supply-chain-bullying-affects-almost-one-in-five-small-businesses-says-fsb-pr-2014-41>

<sup>18</sup> Financial Reporting Council. ‘Corporate Culture and the Role of Boards - Report of Observations’. (2016).

- The profitability of small business.
- The administrative burden on smaller firms who have to divert resources into chasing debts and away from beneficial activities such as business development.
- The number of people employed by small businesses in the UK.
- The quantity of the capital stock available to small businesses and across the economy.
- The total amount of wealth generated by the small business community.

Diagram 1 below illustrates some of the specific annual impacts of the current level of poor payment practices in the UK economy, which result in the detrimental outcomes listed above.

**Diagram one: annual impacts of late payments on the UK economy and small businesses<sup>19</sup>**



The costs of such practices go even wider for small businesses and the economy. It is the issue of outstanding debts that most frequently escalate into commercial disputes between parties. FSB research identified that over seven in ten FSB members, who had been involved in a commercial dispute, reported that they had been involved in a dispute about debt.<sup>20</sup> The debts that reach the level of a dispute tend to be the larger debts. The average amount that a small business ends up in a dispute over is £18,000.<sup>21</sup> Smaller debts are often reluctantly tolerated by small businesses despite their detrimental impact because the commercial relationship the debt is related to, is too valuable to risk or they do not feel they have access to the 'armoury' of knowledge and resources to effectively deal with the dispute.<sup>22</sup>

<sup>19</sup> FSB. 'Time to Act: The Economic Impact of Poor Payment Practice'. (2016).

<sup>20</sup> FSB. 'Tied Up: unravelling the dispute resolution process for small firms'. (2016).

<sup>21</sup> FSB. 'Tied Up: unravelling the dispute resolution process for small firms'. (2016).

<sup>22</sup> FSB. 'Tied Up: unravelling the dispute resolution process for small firms'. (2016).

Commercial disputes generate additional costs of just under £17,000 for those small businesses who are involved in them.<sup>23</sup>

Therefore, taking into account subsequent rounds of costs incurred the total annual cost of poor payment practices to small businesses and the economy is likely to be even greater than £2.5 billion.

Consequently, measured reforms to the corporate governance framework which improved the voice of suppliers at board level in large UK companies and helped drive companies to improve their supply-chain practices can be part of the solution to these supply-chain problems. The long-term benefit for small businesses of effective changes to supply-chain practices would be a permanent improvement in the financial position of large numbers of small businesses. It would also be a competitive advantage for the larger end-customer business and a prosperous economy, producing £2.5 billion more of value added a year.

Therefore, whilst FSB welcomes the legislative steps that have already been taken in the Companies Act 2006 to give directors greater responsibilities with regards to suppliers, there is little evidence to suggest this has resulted in consistent and widespread improvements in the treatment of suppliers. Consequently, we believe there is more that can be done to the corporate governance regime for larger companies to engender that step-change in supply-chain practices that are urgently needed.

### **A multi-faceted approach to improving supply-chain practice**

Change can be achieved through pursuing a package of reforms in parallel each aimed at tackling a different facet of the problem, which together, can help drive a significant cultural change in supply-chain practices across the UK:

- *Embedding supply-chain practice in corporate decision-making.* Progress can be most effectively achieved through a pro-active approach to by larger businesses to address poor payment practices. This can be achieved through large companies formalising their engagement with small suppliers through a statutory voice at the highest governance level in the business.
- *Increasing transparency and public accountability.* There is unlikely to be a better time to introduce changes to the corporate governance framework that will help address these supply-chain problems. 2017 should see the introduction of the Government's new Duty to Report regulations, requiring large businesses to report on their payment practices, policies and performance. These build upon the existing disclosure requirements companies are required to prepare as part of their annual report. FSB welcomes these imminent changes which aim to increase transparency and public scrutiny of large businesses' payment practices.

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<sup>23</sup> FSB. 'Tied Up: unravelling the dispute resolution process for small firms'. (2016).

- *Adequate support, conciliation and spreading best practice.* 2017 will also see the launch of the Small Business Commissioner (SBC). FSB believes the SBC, if endowed with sufficient powers and resources, should have a key role in developing a culture of good commercial contracting and business practice aimed at reducing the incidence of disputes.

### **Good supply-chain practice at the centre of company decision making: the need for a responsible non-executive director (NED)**

Statutory recognition of the voice of small suppliers at the board level should be introduced through a requirement to appoint a non-executive director (NED), with a specific duty to report on behalf of the company suppliers, presenting their findings to their executive board and subsequently including them in the Annual Report. These responsibilities would also include investigating any issues of poor payment practice affecting suppliers and highlighting publicly what has subsequently been done to address them.

We are therefore very encouraged to see that the Government has proposed this as an option in its Green Paper. This clear approach will help ensure that there is much greater transparency in supply-chain practices than currently along with more opportunities for accountability where there is evidence of poor practice.

Introducing a specific duty for a NED to have responsibility for supplier relationships will not be a big change for many of those larger businesses who already adhere to good practice in supply chain management as some already have executive board members with responsibilities for human resources or customer or supplier relations. Such a proposal would mean that this good practice was spread to all larger businesses. With potential examples already in place in some businesses such a proposal would be relatively straightforward for many firms to implement.

FSB strongly believes that there needs to be a director at the board level of large companies to have ownership over supplier interests. This is essential if the Government's proposed corporate governance reforms are to have a noticeably positive impact on changing the UK's payment culture. Whilst FSB recognises the positive intentions of stakeholder advisory panels, small businesses would be concerned that:

- The optionality of such a proposal would lead to inconsistencies in the approach of different large companies as well as the amount of resource invested in ensuring the small supplier voice is heard at the highest level.
- Establishing separate stakeholder advisory panels is likely to lead to further complexity in the governance structures of large companies. Appointing multiple representatives to stakeholder advisory panels and those panels having a vague authority and subordinate status in the governance hierarchy strikes us as a potentially more the costlier, more complex and resource intensive route.

In contrast, our preference for appointing a single Non-Executive Director to represent supplier interests is the simpler and clearer option and builds on what some larger businesses already have in place. This is why FSB argues a statutory route is necessary, not least towards ensuring the interests of small suppliers is robustly represented in a similar way across the big business community.

However, FSB welcomes the Green Paper's suggestion of each designated NED could chair a board-level committee with the status to ensure that executive decision-making takes appropriate account of employee, supplier or consumer issues. Involving other relevant board members in this committee would allow other areas of the company to understand and better engage with suppliers. We welcome the suggestion of the designated NED being a member of the remuneration committee. The types of metrics that could be used for measuring the performance of the relevant company and the effectiveness of the NED can be found in the data that will be available through the Duty to Report, as well as the activity of the SBC, in order to inform decisions about executive pay.

We agree that designated NEDs would need to develop practical ways of ensuring that they have a good understanding of their supply chain. FSB would envisage this person carrying out regular investigations if there is any evidence of, for example, persistent late payment or other poor payment practices or supply chain bullying. It would also be an opportunity to highlight any positive steps taken to improve payment practice. These findings, alongside the designated NED's yearly objectives, responsibilities and activity should then be detailed in the company's annual report to shareholders.

### **General application to all larger businesses**

In order to ensure culture change in UK's payment culture, and specifically the treatment of small suppliers by large companies, we believe these proposals should capture the majority of large firms. We therefore believe the definition of a large company, as set out in the Companies Act 2006, would be the most sensible threshold for the Government to use.

It is imperative that the largest companies, both in terms of their supply chains and brand recognition, take the lead in implementing many of the eventual proposals first. FSB would therefore recommend a gradual roll out with an initial focus on the FTSE 350 companies. Such companies are likely to already be signatories of the Prompt Payment Code and aware of some of the key elements of good supply-chain practice. Corporate governance reforms along the lines set out will ensure that practice is always and everywhere implemented.

### **Taking corporate governance reforms forward**

A NED with a statutory duty for supply chain relationships would require legislation. FSB believes that legislation is the only viable option to drive real and tangible culture change at highest level of the UK's largest companies. Whilst we support voluntary initiatives in this area, it is sometimes unclear what impact they have had in leading to better payment practice. FSB have reluctantly concluded that voluntary measures, while establishing the

kinds of standards that are desirable, they frequently fail to deliver the widespread changes needed.

For example, as of 3<sup>rd</sup> October 2016, there were 1,857 signatories to the Prompt Payment Code. Of these 137 are FTSE 350 companies.<sup>24</sup> There have been claims that some companies, prior to signing up:

*'...increased their payment terms in some cases without negotiation or notice, and by up to 3 times previous contract terms (e.g., 25 to 75 days).'*<sup>25</sup>

In October 2012, the former Minister of State for Skills and Enterprise, the Rt Hon Matthew Hancock MP, wrote to all those FTSE 350 companies not already signed up to the PPC, encouraging them to do so. In spite this, as of January 2013, only 54 had signed up.<sup>26</sup> This is perhaps why FSB research in 2015 found that only one in five (21%) FSB members were confident the Prompt Payment Code (PPC) would be enough to address the UK's poor payment culture.<sup>27</sup> Such evidence suggests the payment practice of large companies will only begin to change when there are stronger incentives in place as FSB has proposed.

FSB would further note that the responsibilities we are proposing a designated NED undertake should not be onerous. In some cases, such activity is likely to already be taking place. Where such arrangements are not in place the additional competitive advantage to be gained from better supply-chain management will more than outweigh any marginal short-term costs due to the new duties taken by a NED. We therefore do not anticipate a disproportionate increase in costs for companies as a result of these changes. On the contrary, FSB expects considerable long-term gains for small businesses, supply-chains, the larger end-customer businesses and the wider economy.

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<sup>24</sup> CICM. 'Prompt Payment Code'. (2016). Available at: [http://ppc.promptpaymentcode.org.uk/ppc/signatory\\_paged.a4d](http://ppc.promptpaymentcode.org.uk/ppc/signatory_paged.a4d)

<sup>25</sup> Abrahams, D. 'The report from the all-party inquiry into late payments to small and medium-sized enterprises'. (2013).

<sup>26</sup> Kamel, A. 'FTSE 100 firms sign up to Prompt Payment Code'. (2013). Available at:

<http://www.telegraph.co.uk/finance/businessclub/9904803/FTSE-100-firms-sign-up-to-Prompt-Payment-Code.html>

<sup>27</sup> FSB. 'Small firms have little confidence in the Prompt Payment Code, says FSB'. (2015). Available at:

<http://www.fsb.org.uk/media-centre/press-releases/small-firms-have-little-confidence-in-the-prompt-payment-code-says-fsb-pr-2015-11>

## The governance of smaller firms

Most of the 1.8 million actively trading companies in the UK are small.<sup>28</sup> Therefore, as well as a corporate governance framework that helps improve business culture across the UK's large business supply-chains, small businesses need a company legal framework that is open and flexible and which, consequently, enables small business success.

On the whole, FSB considers the current corporate governance framework in the UK works relatively well for smaller businesses and does enable small businesses to succeed. The Common Law legal framework that has evolved (through the interaction of judge made and statutory law) in the UK is well established, robust and respected. It is notable for the strong protections it provides for investors and creditors.<sup>29</sup> By establishing a set of clear and certain rules based on enduring principles but applied flexibly the current regime encourages high levels of commercial activity.<sup>30</sup>

Therefore, FSB does not see a case for significant change to the corporate governance regulatory regime impacting on smaller businesses. Certainly its existing strengths need to be maintained. However, FSB believe that by building on its currently internationally recognised strengths the UK's company law regime could be further enhanced to better suit the circumstances of smaller businesses. We believe there is a case for a package of small business focused changes which will further improve the current framework and result in a legal framework which will support small business start-up and growth even more effectively than now.

## The nature of small business and the consequences for governance

Small businesses (due to their inherent characteristics and circumstances) are significantly different from larger businesses, in a number of ways:

- Small businesses are very heterogeneous and consequently the variation within the population (e.g. in terms of business models, market conditions, customer characteristics, incentives, risk appetite and motivations) is much greater than the variation within the big business population.
- In general smaller businesses have much more limited access to resources, a different risk profile and much less market power than larger businesses.

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<sup>28</sup> ONS/ BEIS. 'Business Population Estimates for the UK and Regions 2016'. (2016).

<sup>29</sup> The UK ranks sixth in the world for investor protections. Source: World Bank. 'Doing Business United Kingdom 2017: Equal Opportunity for All – 14<sup>th</sup> Edition'. (2016).

'Common law countries have the strongest protection of outside investors –both shareholders and creditors'. Source: Rafael La Porta, R., Florencio Lopez-de-Silanes, F., Shleifer, A and Vishny, R. 'Investor Protection and Corporate Governance'. Journal of Financial Economics, Vol 58, No 1–2. (2000).

<sup>30</sup> '...legal investor protection is a strong predictor of financial development'. Source: La Porta, R., Lopez-de-Silanes, F and Andrei Shleifer, A. 'The Economic Consequences of Legal Origins'. Journal of Economic Literature, Vol 46, No 2. (2008). Further, '...national legal rules protecting investors improve the ability of firms to develop company-specific corporate governance mechanisms'. Source: Aggarwal, R. et al. (2008) cited in La Porta, R., Lopez-de-Silanes, F and Andrei Shleifer, A. 'The Economic Consequences of Legal Origins'. Journal of Economic Literature, Vol 46, No 2. (2008).

- There are fewer formal structures, procedures and hierarchies in small firms as a result of a less extensive internal division of labour compared to larger companies.
- Ownership is more concentrated, often family-based, and frequently indistinct from management.<sup>31</sup> The latter is often more informal and less professionalised.<sup>32</sup>

The multiplicity of differences between smaller and larger businesses have important implications for the kinds of factors which influence the choices smaller businesses make about their governance. Table two below elucidates on some of the factors and the implications of those factors for choices over governance.

**Table two: factors behind governance choices in smaller businesses**

Factor	Implications
The extensive overlap between ownership and management.	Where there is a high degree of cross-over between ownership and management the prominent agent-principal issues, which are the key driver of corporate governance structures and practices in large companies, are less pronounced in smaller businesses (though they do exist). <sup>33</sup> At the same time, close integration between ownership and management can make it difficult to attract outside investors. Other dynamics also frequently play a part. For example, family ownership brings with it additional dynamics i.e. 'family cycles', that can have an important bearing on governance. <sup>34</sup>
The importance of the maturity of the business.	The stage of development and growth trajectory of the business mean that at different times different approaches to governance are often required. <sup>35</sup> A start-up will require dramatically different governance to a more 'established' small business whose priority is consolidation of its market position and further product or production process development. <sup>36</sup>
Other business-specific factors e.g. owner ambitions, risk appetite, sector etc.	Business and owner characteristics can be determinative of governance approaches. <sup>37</sup> Some approaches to governance are more appropriate for certain types of businesses or owners than others e.g. the governance requirements of a self-employed plumber is going to be very different to a hi-tech software

<sup>31</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>32</sup> Crossan, K and Henschel, T. 'Corporate Governance: An Holistic Model for SMEs'. Journal of Management and Financial Services. Vol 5. (2012).

<sup>33</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>34</sup> 'Family cycles' include issues such as succession planning, family dynamics and life-events such as marriages and divorces, birth of children and death. Source: Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>35</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>36</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>37</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

	company founded by team of entrepreneurs. The sector the business operates in can play a strong role in determining the approach to governance too. <sup>38</sup>
Governance - management linkages (i.e. strategy, risk management, business planning). <sup>39</sup>	<p>The interlinking of governance with strategy, risk management and business planning comes because:</p> <ul style="list-style-type: none"> <li>• Smaller businesses choose incorporation for a range of practical benefits such as risk reduction, attracting capital or leveraging outside expertise. Adopting a particular 'model of governance' is usually the least important reason; and</li> <li>• Management in smaller enterprises tends to be more informal and less hierarchical compared to that in larger businesses.<sup>40</sup></li> </ul>

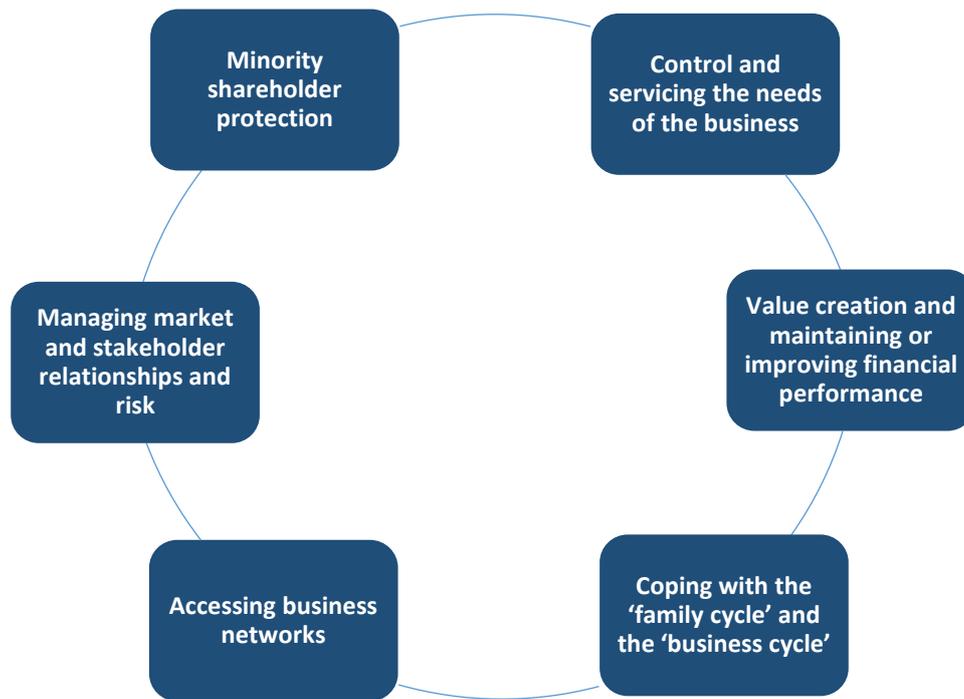
The range of factors outlined in Table two above result in the need for the governance arrangements in small businesses to achieve a wide range of objectives. Yet some of these objectives are hard to balance in the context of the constrained resources of a small business and have to be balanced against each other. These objectives are illustrated in diagram two below.

<sup>38</sup> Bertoni et al. (2012), Uhlener (2012) and Filatotchev and Allcock (2012) cited in Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

<sup>39</sup> Crossan, K and Henschel, T. 'Corporate Governance: An Holistic Model for SMEs'. Journal of Management and Financial Services. Vol 5. (2012).

<sup>40</sup> Crossan, K and Henschel, T. 'Corporate Governance: An Holistic Model for SMEs'. Journal of Management and Financial Services. Vol 5. (2012).

**Diagram two: the objectives of governance in small business<sup>41</sup>**



As a result of this range of multiple objectives the approach to governance taken by an individual small business is likely to vary considerably depending on their particular characteristics and circumstances.

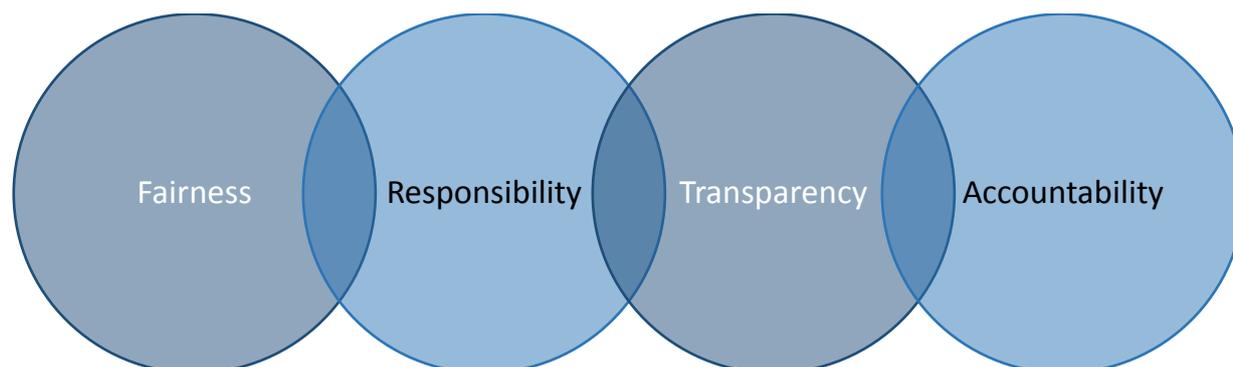
The implications for the legal framework of this complexity are numerous. A framework is needed that does not stifle the diversity in the small business community as this is one of its strengths. In other words, it should not be too prescriptive but rather should leave room for innovation and adaptation. By doing so it will enable small businesses to succeed as long as the flexible framework is solidly based within a clear set of simply understood parameters which offer certainty about rights, responsibilities and protections.

The current company law framework does, on the whole, manage to achieve these ends. This is as a result of its traditional strengths of being based on the flexible application of a clear set of established Common Law principles that incentivise commercially beneficial behaviours within and between businesses. The four principles necessary to govern a

<sup>41</sup> Li, Y. 'Governance, Regulation and Performance of Non-listed Small Corporations in Australia: A Structural Equation Modelling Approach'. (2014).

business effectively and embedded in the existing Company Law regime, are listed in diagram three below<sup>42</sup>

**Diagram three: four principles of good governance**



The Common Law approach has evolved a corporate governance framework that ensures businesses subject to it meet these four principles. How this is achieved is set out in Table Three below.

**Table three: how the four principle of good small business governance are reflected in the UK’s company law framework**

Principle	How the principle is reflected in the existing framework
Fairness	The current regime ensures a good degree of fairness by, for example, robustly protecting minority shareholders <sup>43</sup>
Responsibility	Company law is based upon robust and long-standing principles and rules on director responsibility which can be flexibly applied <sup>44</sup>
Transparency	The framework requires a good deal of transparency from businesses about their finances <sup>45</sup>
Accountability	The combination of legal duties and rights in the law, backed up by ways of obtaining redress and suitable sanctions ensure there is a degree of accountability for the actions of those running businesses <sup>46</sup>

<sup>42</sup> Ramaswamy, V., Ueng, C. J. and Carl, L. ‘Corporate governance characteristics of growth companies: An empirical study’. Academy of Strategic Management Journal, Vol 7, No 1. (2008).

<sup>43</sup> The UK ranks 8 out of 10 for both shareholder rights and ease of shareholder suits. Source: World Bank. ‘Doing Business United Kingdom 2017: Equal Opportunity for All – 14<sup>th</sup> Edition’. (2016).

<sup>44</sup> ‘The expansion of legal precedents to additional violations of fiduciary duty, and the fear of such expansion, limit the expropriation by the insiders in common law countries...The...fiduciary duty principles of the common law are more protective of investors than the bright line rules of the civil law, which can often be circumvented by sufficiently imaginative insiders’. Source: Rafael La Porta, R., Florencio Lopez-de-Silanesb, F., Shleifer, A and Vishny, R. ‘Investor Protection and Corporate Governance’. Journal of Financial Economics, Vol 58, (1–2). (2000).

<sup>45</sup> The UK rates 8 out of 10 in the World Bank rankings for corporate transparency. Source: World Bank. ‘Doing Business United Kingdom 2017: Equal Opportunity for All – 14<sup>th</sup> Edition’. (2016).

<sup>46</sup> ‘Legal rules in the Common Law system are usually made by judges, based on precedents and inspired by general principles such as fiduciary duty or fairness. Judges are expected to rule on new situations by applying these general principles even when specific conduct has not yet been described or prohibited in...statutes’. Source: Rafael La Porta, R., Florencio Lopez-de-Silanesb,

## The remaining problems with the current framework

The picture briefly outlined above illustrates why significant reform to the current law is not needed. Nevertheless few regulatory regimes are perfect. The Company Law regime is no exception. There are aspects that do not work as well for small businesses as they might. Consequently, FSB consider that there are ways in which the current regime can better help small businesses fulfil their governance (and in-turn business) objectives.

The current framework could be further tailored to take more account of the nature and needs of smaller businesses and in particular the smallest. Specifically, the current legal framework:

- Is too complex to understand for the very smallest businesses.
- Requires small businesses to buy-in compliance advice and is consequently inextricably linked to additional compliance costs.
- Continues to make, what many FSB members consider, onerous reporting, recording and monitoring demands of the smallest businesses.
- Could be more proportionately enforced with a stronger focus on negligent and malfeasant directors.

As one self-employed FSB member running a professional services business in the South East of England stated about the current framework:

*'Company Law is too broad...a one man limited company with a turnover of under £80,000 is governed mainly by legislation which applies to a company with a turnover of £600,000'.*

A self-employed member running a retail business in Wales described the present regime as:

*'...daunting and expensive for the small business, so it is difficult for a small business to limit its liability...'*

## Recognising smaller businesses more explicitly in the company law regime

The corporate governance regime could benefit from a clearer and more consistent recognition of the different nature of small business than it currently contains. With the proposed changes in the Government's Green Paper adding further differences to the existing divergence between the corporate governance regime pertaining to larger businesses and that to smaller businesses, a more formal recognition of the differences between large businesses and smaller businesses should be taken forward across the existing corporate governance regime. This does not mean measures which undermine the strengths of the current framework. On the contrary, reflecting the differences between smaller and larger businesses in the legal framework should be about maintaining its current

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F., Shleifera, A and Vishny, R. 'Investor Protection and Corporate Governance'. Journal of Financial Economics, Vol 58, (1-2). (2000).

strengths but reflecting them in the law and its requirements in a more small business focussed way.

A first step to developing a more nuanced framework which will deliver long-term tangible benefits for small business requires a clear understanding of which are the essential elements of the corporate governance regime for small businesses i.e. those that are most salient for running a successful small business. The three essential elements of the current legal framework most important for the governance for small businesses are set out in Table four below.

**Table four: essential elements of the corporate governance framework for small businesses**

Essential element	Description
Command and control	The structure of governance in a business and the rules for controlling the strategic activity of the business.
Business dealings	Responsibilities of director's in commercial dealings related to the business, oversight of managers in the latter's commercial dealings on behalf of the business and other commercial actions which affect the interests of investors, especially shareholders.
Finance and solvency	Stewardship of the business's financial position and the rights and duties of owners and directors in the context of insolvency.

In order to reflect the position of small businesses in the law, the company law framework should be made more nuanced. This can be achieved by basing the development of that more nuanced framework on the following five propositions:

- *Flexibility* - change should avoid negatively impacting the existing flexibility in company law. Small businesses need to have a high degree of discretion over how they organise their governance therefore remaining unnecessary restrictions should be deleted for the smallest enterprises.
- *Simplification* - reforms should seek to simplify the regime for small businesses as much as possible by lessening the complexity of the drafting of the law and trimming back the monitoring, recording and reporting requirements (and the associated costs incurred by small businesses having to buy-in compliance advice) required by the existing law for the smallest companies.
- *Investor protection* – changes should be aimed at enhancing the traditional strong baseline set of protections for investors that exist in company law, in particular minority shareholders. Investor protections are an essential component in an effective system of private property rights and are vital to encourage a confident investor community that is willing to supply risk finance to smaller businesses at affordable rates. Common Law countries such as England and Wales have been particularly good at protecting such

rights.<sup>47</sup> Therefore enhancement of these will help further reduce the risks for investors in smaller businesses.

- *Accountability* – maintain the current clarity around directors’ duties. Ensuring the existence of a high trust trading environment for small businesses requires a robust framework to deal with and reduce the number of malfeasant directors. This requires adequate powers and resources for both Companies House and the Insolvency Service. Similarly, private parties with a just claim need to have the appropriate tools at their disposal in order to seek redress against such directors.
- *Support* – small businesses need basic support to help them comply and take full advantage of the benefits of incorporation. For the vast majority of small businesses failure to comply is through lack of knowledge and constrained resources not deliberate intent. While accountants, company secretaries, business representative groups and trade bodies provide information its fragmented nature reduces its ability to reach the widest possible audience. Further, the guidance offered by such organisations is often detailed and tailored to their membership. Therefore there needs to be a focus by Companies House on basic and simple support and advice aimed at small businesses about how to reap the full benefits of limited liability and help small businesses to be fully compliant.

FSB believes the Government should implement a package of measures which will enhance the company law framework for smaller (and especially the smallest) businesses based upon these five propositions outlined above. Table five below illustrates how such a package of measures can help improve the current framework in those three core areas most salient to smaller businesses and makes a number of specific proposals for change to deliver the objective of a more nuanced legal framework.

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<sup>47</sup> ‘Common law countries have the strongest protection of outside investors –both shareholders and creditors’. Source: Rafael La Porta, R., Florencio Lopez-de-Silanes, F., Shleifer, A and Vishny, R. ‘Investor Protection and Corporate Governance’. Journal of Financial Economics, Vol 58, (1–2). (2000).

**Table five: reforms to the corporate governance framework to help small businesses**

	Policy reforms		
	<i>Simplification</i>	<i>Support</i>	<i>Accountability</i>
	<ul style="list-style-type: none"> <li>Begin the process of reviewing the impact of the Companies Act 2006 within the next five years. While the general legal framework works well (as described above) there is room for some improvements to company law and in particular scope for simplification through consolidation and re-drafting as well as changes that could help the law better reflect the particularities of small business, their priorities and needs.</li> </ul>	<ul style="list-style-type: none"> <li>Developing more small business specific information and guidance about governance issues, their importance and the benefits of good governance for small businesses.</li> <li>Companies House should work closely with the new Small Business Commissioner (SBC), small business groups and professional bodies (e.g. accountants, solicitors and company secretaries) to develop new basic guidance for small businesses.</li> <li>Such activity will need to be suitably resourced.</li> </ul>	<ul style="list-style-type: none"> <li>Greater resources for Companies House to focus more pro-actively on investigations into and actions against malfeasant directors.</li> </ul>
<i>Command and Control</i>	<ul style="list-style-type: none"> <li>A simplified set of Model Articles for the smallest companies should be inserted into the Company Law regime. This should be particularly focussed upon creating a simple i.e. 'easy to understand and use' set of articles for businesses where the owners and managers are the same.</li> </ul>		
<i>Business dealings</i>	<ul style="list-style-type: none"> <li>A review of the current range of investor protections. The comparative World Bank rankings suggest there is scope to move the UK further up the international league table. Therefore, as part of the Government's new look at corporate governance, the Government should consider the case for strengthened investor rights. In particular, this should include looking at the scope for the simplification and enhancement of the rights and access to affordable procedures for bringing 'Unfair</li> </ul>		

	<p>Prejudice’ and ‘Derivative’ claims. Where related protections are found outside of company law e.g. insolvency law (with principles such as ‘just and equitable winding-up’ actions) these should also be included in any review to ensure a holistic approach.</p>
<p><i>Finance and solvency</i></p>	<ul style="list-style-type: none"> <li>• A further look at the liabilities of directors in the context of insolvency. A problem for many smaller businesses who are creditors is directors who have acted negligently or trade fraudulently not being held accountable sufficiently robustly. FSB acknowledge that there have been recent (and welcome) changes to aspects of the law in relation to tackling malfeasant directors in the Small Business, Enterprise and Employment Act 2015. However, the position of small businesses and the wider trading environment could be further enhanced by a more holistic look at the legal framework in this area. Issues worth looking at include how the powers and sanctions available to the Insolvency Service interact with a range of possible civil options available to creditors and investors and the complementarities between insolvency and company law. The review should form part of a holistic review also looking into investor protections described above. This part of the review should aim to identify any gaps and tidy-up the law where needed through the establishment of a comprehensive regime governing this aspect of the commercial legal framework.</li> </ul>