



The relevance of agency conflicts in small and medium enterprises

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ABSTRACT

The agency theory posits that the separation of control and ownership in firms leads to agency conflicts. Previous studies have focused on the relevance of these conflicts in large public listed companies; however, very few studies have demonstrated the role of agency conflicts in small and medium enterprises. This paper has presented theoretical and conceptual arguments regarding to types of agency conflicts prevail in SMEs and the solutions to mitigate them. Firstly, this study has demonstrated the conflicts of interest emerge between creditors and managers. It is postulated that underinvestment (debt overhang) issue can be resolved through short-term debts, the asset substitution (risk-shifting) problem can be mitigated by aligning the economic life of asset with debt maturity and overinvestment issue is likely to be reduced by increasing debt maturity. Secondly, to overcome principal-agent conflict, it is recommended that SMEs should have demand for voluntary external auditing regardless of their size to improve the monitoring mechanisms in the firms. This paper has also specified the directions for futuristic research especially in the context of developing economies.

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1. Introduction

Corporations with high profitability prefer to makes internal funds in order to expand their operations (Monsef, 2015). Nonetheless, early stage firms or start-up ventures could face several issues in sourcing finance for investment. In the sense of financing, their internal equity is circumscribed because the connections and personal resource of the venture owner may be restricted and the retained earnings are usually inadequate. In addition, due to lack of collateral assets, potential agency problems and information asymmetries their access to external finance could also be constrained. Therefore, despite of moving toward financial institutions, usually early stage firms or start-up entrepreneurs find business angels or private investors as the resort to external equity (Berger and Udell, 1998). Especially in strategically targeted industry, external equity financing can be acquired from tax incentive equity schemes and government grant schemes. However, venture capitalists always

attracted toward the ventures with high-growth potentials especially where service or produce has been pre-tested (Kerins et al., 2004). Nevertheless, with the growth of firm, separation of management and control is possible which could leads potential agency conflicts when principals hire the agent and he does not work in the best interest of principals (Jensen and Meckling, 1976).

Agency theory proposed by Jensen and Meckling (1976) deals with the owners of business enterprise and its stakeholders, i.e. employees, family members, creditors, banks etc. Generally, the theory has identified different problems that could be relevant to small and medium enterprises. For instance, agents could involve themselves in information asymmetry. They could conceal the financial prospects and circumstances of the venture from the principals (Emery et al., 2004). This lack of transparency could leads to severe agency conflicts in a business enterprise. In addition, through information asymmetry, agents could falsify their abilities and skills and could exploit the resources of principals in an unseen manner. Researchers have proposed different solution for this problem, e.g. creditors may increase the rate of interest they get from the venture or shareholder could increase the reward for agent.

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It has been previously argued that agency theory is not relevant in the context of small businesses because owners and managers in small enterprises are same (Emery et al., 2004). However, it is purported that although the main agency conflicts in small enterprise is not usually between managers and owners but between outside and inside capitalists (Hand et al., 1982). Possible agency conflicts in small and medium enterprises are aggravated by information asymmetries emerging from lack of uniform, publicly available detailed accounting information. The main purpose of this study is to identify the agency conflicts and explore the agency theory in perspective of SMEs. Previous studies have focused less on the relevance of agency theory in small and medium businesses.

2. Literature review and hypothesis development

In the initial phases of the foundation of an SME, the attention of its administration tends to be narrow, for instance, building associations with regulatory bodies, customers, suppliers and investors, final alterations to a product or service in preparation of its preliminary launch. A more sophisticated firm structure will be necessary, business will expand in the context of complexity, managerial scope and scale and eventually the SME will continue to grow if these primary stages are successful. SME does not function in a vacuum so it is influenced by external forces which need to be controlled by separate departments. Organizational sophistication requires adequate formulating and monitoring which newly developed SMEs usually do not possess. Therefore, business angels, financial institutions and private investors feel hesitate in providing external funding. SMEs are also deficient in the areas of financial and accounting reporting systems which is required for organizational sophistication. Moreover, when monitoring and managing SMEs become more complicated, it leads to separation of managerial control and ownership. With this separation, there is possibility that not all parties may share the objective of revenue generation leading to the adverse effect on SME performance (Berle and Means, 1932; Fama and Jensen, 1985; Jensen and Meckling, 1976).

The conflict of objectives between owners and managers is not relevant in small businesses because ownership and management is not separated in these firms, however, it can be arisen in Medium enterprises if these are not owner-managed. Non-owner managers could work in their own best interest due to different priorities like power, personal prestige, firm's valuation ratio, market share, risk taking, sales revenue, growth maximization and other related factors. Nevertheless, in most of the markets, the principal-agent conflicts in SMEs are less prominent due to higher influence of owners in this sector. However, the conflicts between debt capital providers and managers are noticeable in small and medium enterprises. Conflicts in SME sector emerge between

outsiders and insiders, i.e. providers of debt capital and agents. Mainly these conflicts arise due to information asymmetries. Managers in SME generally hold comparatively superior firm-specific information but they could conceal it from lenders or investors. Substantial information asymmetries can develop due to cultural factors, local disclosure requirements, and legal status of the SME, causing the debt provider to become the victim of moral hazard and adverse selection.

2.1. Debt maturity structure

Researchers have addressed almost three agency conflicts between lenders and owners in determining the SMEs' debt maturity. Myers (1977) has identified the problem of underinvestment in SMEs. Financial markets feel tentative in term of providing equity to SMEs because they are usually very much in debt. SMEs possess less fixed assets so due to their young nature, they enjoy greater growth opportunities. Therefore, it is suggested that underinvestment issue can be resolved by issuing debt with a shorter maturity with the settings of growth opportunities and debt. Secondly, as small businesses possess less fixed assets on their financial statements so the issue related to risk-shifting and asset substitution can also be observed in these businesses (Jensen and Meckling, 1976). In this case, monitoring the success of small ventures by debt provider become challenging. Thus, providing short-term debt could also solve this problem as debt provider can evaluate the success of firm through utilization of borrowed funds. Thirdly, the issue of free cash flow or overinvestment has been identified by Jensen (1986). SMEs become increasingly complicated with their growth which also leads to separation of ownership and management (Schulze et al., 2001). Consistent with this argument, Stulz (1990) postulated that managers can be restricted from the exploitation of owner's resources by utilizing financing policies. To mitigate this type of agency conflict or to restrict managers from overinvestment, debt payments (usually long-term debts) can also be used as a control mechanism.

Prior studies suggested that agency conflicts stemming from debt contracts can be mitigated through an optimum policy for debt maturity (Lopez-Gracia and Mestre-Barberá, 2015). Debt overhang or underinvestment issue emerges when managers or owners in SMEs who obtain loan renounce positive NPV investments. In this scenario, the owner recognize that he or she will undertake all the risk of the investment with lower gain in business and higher benefits to creditor. Consequently, debt contracting in the present to invest current opportunities can cause an underinvestment issue in the future. This issue is specifically prominent in SMEs because usually there are highly in debt. Many researchers have suggested that this agency problem can be mitigated with the reduction in debt maturity as before the investment is made, the debt will be matured (Barnea et al.,

1977; Smith, 2007). Thus, considering the postulations of previous studies, the hypothesis can be formulated as follows:

H₁: Underinvestment agency problem in SMEs is likely to be mitigated by reducing the debt maturity.

The second agency problem face by SMEs is risk-shifting or asset substitution problem as evaluated by Jensen and Meckling (1976). The problem arises when SME debt holders try to invest in risky projects instead of low risk ventures. At the expense of lender, SME owners make an attempt to enhance their wealth. This problem is mostly observed in small business ventures where owner realize that most of the risk burden has to face by creditor in case of business failure. Moreover, small business is already indebted so high risk-taking or venture failure will adversely affect creditor more than debtor. Therefore, to reduce this risk, creditors specify some rules and clauses while contracting debt. Moreover, Barnea et al. (1980) suggested that short-term debt policy can be utilized to mitigate this issue of moral hazard. Short-term debt financing will also allow the creditor to monitor the risk-taking behavior and firm performance on regular intervals (Jun and Jen, 2003). Myers (1977) also posited that this issue can also be resolved by matching the economic life of assets to debt maturity. The problem of asset substitution is more prominent in small firms due to the greater proportion of current assets rather than fixed asset. Therefore, it is hypothesized that:

H₂: Risk-shifting agency problem in SMEs is likely to be mitigated by aligning the economic life of assets to debt maturity.

Free cash flow or overinvestment problem has not been viewed in small businesses where management and ownership remain in the hand of one person. However, with the expansion in business, owner allow someone else (agent) to take decision on his behalf to enhance profitability but it is possible that the agent will work in his own best interest. Moreover, the new decision makers could misuse the available free cash flows by investing them in unsuccessful ventures. There are less control structures and concentrated ownership in small firms; therefore, the issue of overinvestment becomes more prevalent in these firms (Danielson and Scott, 2007). Probably, small businesses renounce (foster) growth if the agency costs derived from overinvestment are higher (lower) than the benefits gained. However, it is suggested that agency costs can be minimized by investing in decision hierarchies.

Despite of its prominence, there is lack of evidence in the perspective of SMEs' ownership-management separation. Moreover, the views regarding the solution to this agency problem are contrary. For instance, Kaplan (1999) suggested utilizing short-term debts for the superior monitoring, on the other hand, Hart and Moore (1995) have recommended that long-term debts can mitigate the overinvestment issue as it restricts managers from investment in less profitable projects

by borrowing against future earnings. In the same lines, through evidence from Finish SMEs, Lopez-Gracia and Mestre-Barberá (2015) also revealed that long-term debts could mitigate the overinvestment problem. Thus, considering all the arguments, following hypothesis has been generated:

H₃: Overinvestment agency problem in SMEs is likely to be mitigated by increasing the debt maturity.

2.2. Demand for audit

Owing to the fact that agency conflicts emerge in SMEs with their growth and with the separation of ownership and management, the demand for audit service increase. Efficient auditing can mitigate the potential agency conflicts as it acts as monitoring mechanism (Niskanen et al., 2010). In developing countries, only large and public listed companies demand for the auditing of their financial statements. Most of the small and medium enterprises do not invest in the auditing of their accounts. However, researchers revealed that some small and medium enterprise is also willing to have their accounts audit even in an informal setting (Kaur and Kurt, 2008).

Francis et al. (2006) assumed that firm-specific incentives (contracting and agency costs) could encourage SME owners to demand voluntary external auditing. Auditing does not only mitigate agency conflicts but also enable the owners to concentrate on core business functions rather than spending additional time and burden to manage the accounting activities (Kaur and Kurt, 2008). Small and medium enterprises are much less regulated; they function in a much more opaque information environment and less exposed to publicity, litigation, and market forces. Therefore, the role of auditing is less obvious in these firms as compared to public listed firms. However, to mitigate potential agency conflicts, Mustapha, Yaen and Ismail (2015) suggested that SMEs should carry out an audit regardless of their size. Accordingly, the following hypothesis has been generated:

H₄: Potential agency conflicts in SMEs are likely to be mitigated through voluntary demand for external auditing.

3. Discussion and conclusion

This paper is conceptual review related to the agency conflicts emerge in small and medium enterprises. Start-up ventures usually need external financing to survive or to grow in a market place. Nevertheless, potential agency conflicts also arise with the growth in business. Small firms usually face the conflicts between owner and creditor; however, medium enterprise could also suffer from the principal-agent problem. Jensen and Meckling (1976) have discussed different types of agency conflicts that could be between any of the stakeholder. For instance, agents could involve themselves in empire building and work in their own

best interest rather than debt provider or principal. They could manipulate the creditors and principals through information asymmetry which give rise to severe agency conflicts in an organization. Previous researchers have proposed different solutions like utilization of independent directors on board; activism of institutional investors, better compensation plans or higher interest rates to mitigate agency conflicts, however, most of these studies has been conducted on large public listed companies. The relevant academic literature in the perspective of SMEs is very scarce.

The conflict between agent and principal is almost absent in small businesses because ownership and management is not separated. Nevertheless, the conflicts between insider and outsider capitalists are prominent in these types of firm. This paper has identified three main types of agency conflicts emerge in SMEs, i.e. underinvestment (debt-overhang) problem, asset substitution (risk-shifting) problem and overinvestment (free cash flow) problem. In the context of underinvestment issue, it has been argued that with the increase in growth opportunities, the debt maturity will be decreased. If a company possess greater investment or growth opportunities then it is more likely to use short-term financing in order to mitigate the incentives to relinquish profitable investments. These circumstances will also make the banks capable of safeguarding their business portfolio. Through previous studies, it has been revealed that underinvestment problem can be mitigated by reducing the debt maturity. By providing short-term debts, creditor could monitor the business performance effectively.

Secondly, this study has identified risk-shifting or asset substitution problem prevailing in SMEs. At the expense of lender, SME owners or managers could shift the low risk projects to riskier ones through current assets. Therefore, it is proposed that debt providers should align the economic life of their assets to debt maturity. Thirdly, the problem pertaining to overinvestment or free cash flow has also been identified. Managers can use excess free cash flows to invest in unprofitable projects, therefore, to restrict managers from this misappropriation; SMEs should be financed by long-term debts. Nevertheless, for effective monitoring by lender, they should provide short-term debts rather long-term debts. Financing with short-term debts will help in reducing moral hazard or adverse selection problem along with greater control on risk of default and operating activities. Therefore, there is an immediate need of further study on SMEs in this context on different developing markets because agency conflicts can also contribute toward SME failure.

It is also recommended that regardless of their size, SMEs should employ external auditors to mitigate agency conflicts, improve financial statement quality and to save additional time and burden on accounting related activities. It is hypothesized that the SMEs who carry out voluntary

external auditing are more likely to have lesser agency conflicts. In developing countries, the corporate governance structures are weak and spontaneous as compared to developed countries. There is concentrated ownership by family members in SMEs which leave no room to other ownership structures. However, it is suggested that if government and regulatory bodies will improve the corporate governance structures in SMEs of developing countries then institutional owners could actively participate in decision making leading to effective monitoring (e.g. see Abor and Biekpe, 2006). Effective monitoring could result in more debt being used by managers to maximize shareholder wealth.

It is also asserted that protection against conflicts of interests begins with due diligence. Creditors should investigate managerial capabilities, current market conditions, and assessment of available collateral and SME's experience with previous creditors. Creditors could decrease the information asymmetry by negotiating treatment as a quasi-insider or by taking an equity position in SME. Effective monitoring by creditors will improve the level of collateral, long product history, credit history and disclosure policies.

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