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## **Corporate Governance and Small Medium Businesses**

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# Corporate Governance and Small & Medium Businesses

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## 1. Different Definitions of Corporate Governance

In the past ten years corporate governance has become an increasingly important issue throughout the world. Governments and regulators became aware that sound corporate governance not only reduces the number of corporate scandals, but it contributes to sustainable economic development by enhancing performance of companies, strengthening institutions, protect the public and increasing access to external sources of capital. “Companies implementing good corporate governance create value and provide accountability and control systems equivalent to the risk assumed. They are committed to enabling harmonious relationships among all stakeholders.” (IFC, 2007)

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Because of the growing popularity of the term, ideas, opinions and definitions of corporate governance are constantly developing, making it difficult to choose from the series of definitions a comprehensive one, explaining precisely and concisely its substance. Some definitions limit the meaning of corporate governance only to the relationships within a company, whereas others emphasize its meaning to the relevant social context. Some focus in the financial aspects of corporate governance, some on its legal background.

The 1992 Report of the UK Committee on the Financial Aspects of Corporate Governance<sup>1</sup> (CFACG and Gee and Co. Ltd., 1992) describes corporate governance as “the system by which companies are directed and controlled.” The Institute of International Auditors’ definition of corporate governance is similar, but adds some components to the system: “governance is the combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.” (IIA, 2011)

Professors Andrei Shleifer and Robert W. Vishny<sup>2</sup>, both agree that “corporate governance deals with the way suppliers of finance assure themselves of getting a return on their investment.” (Shleifer & Vishny, 1997)

Sir Adrian Cadbury<sup>3</sup> considers that “corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require

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<sup>1</sup> Known as the Cadbury Report; The Committee on the Financial Aspects of Corporate Governance, known as the Cadbury Committee, has been established in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The spur for the Committee's creation was an increasing lack of investor confidence in the honesty and accountability of listed companies, occasioned in particular by the sudden financial collapses of two companies, wallpaper group Coloroll and Asil Nadir's Polly Peck consortium

<sup>2</sup> University of Harvard and University of Chicago renowned professors and researchers in the field of finances and capital markets

<sup>3</sup> Director of the Bank of England from 1970 to 1994 and of IBM from 1975 to 1994, promoter of the corporate governance debate.

accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.” (Global Corporate Governance Forum, 2003)

Most widely accepted definition is the OECD definition, according to which “corporate governance is the system by which business corporations 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.” (OECD, 2003)

Most of the existing definitions and past and present practice show that corporate governance is almost always considered in the context of large publicly traded companies i.e. companies to have sound corporate governance system regulated by law.

This Paper however is based on the assumption that it is as important for privately held, small and medium businesses to adhere to good corporate governance policies and practices. Accountability, as one of the basics, may become key economic driver and job creator in most of the countries. That said, according to US Office of Advocacy estimates, in 2009, there were 27.5 million small and medium businesses in the United States (Kobe, 2007) which gives excellent starting point to develop sound corporate governance practices and improve their performance both internally and externally. As businesses grow and stakeholders increase, corporate governance becomes even more important, as there are many people with vested interests. Yet many small and medium businesses do not necessarily pay attention to the concept of corporate governance. Most of them do not even have the necessary organizational setting and knowledge to shape and promote it.

The purpose of this Paper is to bring closer the concept of corporate governance to small and medium businesses and assist them in achieving higher level governance. By identifying the best practices that many large companies have established, and adopting the same to the specifics

and the needs of the small and medium businesses, this Paper should help create more transparent, organized, effective and sustainable businesses.

## **2. Specifics of Small and Medium Businesses**

Small and medium businesses - SMBs (also called small and medium enterprises – SMEs) are companies whose headcount or turnover falls below certain limits. In most economies, smaller enterprises are much greater in number than large companies. However we are witnessing the growing number of smaller v. s. larger ones in strong economies as well. SMEs are often said to be responsible for driving innovation and competition in many economic sectors.

According to the European Commission's Article 2 of the Annex to Recommendation 2003/361/EC, "the category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million". (Communities, 2003) SMEs are the backbone of the EU economy - they represent 99 % of all enterprises in the EU. Some 23 million SMEs provide around 75 million jobs. (European Commission , 2005)

However, size based definitions are problematic as a small increase in sales or employee numbers would catapult the company into the next higher category without significant change to its underlying characteristics. (Preuss & Perschke, 2010)

"Micro, small and medium-sized enterprises (SMEs) are the engine of the European economy. They are an essential source of jobs, create entrepreneurial spirit and innovation in the EU and are thus crucial for fostering competitiveness and employment. The new SME definition, which entered into force on 1 January 2005, represents a major step towards an improved business environment for SMEs and aims at promoting entrepreneurship, investments and growth. This definition has been elaborated after broad consultations with the stakeholders involved which proves that listening to SMEs is a key towards the successful implementation of the Lisbon goals"

- wrote Günter Verheugen, member of the European Commission (EC) responsible for Enterprise and Industry in the User Guide and Model Declaration of the new SME definition. (European Commission , 2005)

EU Member States traditionally have had individual definitions of what constitutes an SME. For example, the traditional definition in Germany has a limit of 255 employees, while Belgian one has a limit up to 100.

In July 2011, the European Commission said that it would open a consultation on the definition of SMEs in 2012. In Europe, currently there are three broad parameters which define SMEs — micro-entities are companies with up to 10 employees; small companies employ up to 50 workers, whilst medium-sized enterprises contain up to 250 employees. (Communities, 2003)

The definition varies insignificantly in the United States of America (USA). The Small Business Administration sets small business criteria based on industry, ownership structure, revenue, and number of employees, which in some circumstances may be as high as 1500 though is typically capped at 500. (USSBA, 2011)

Both the US and the EC generally use the same threshold of fewer than 10 employees for small offices.

Regardless of the size of the SME, the corporate governance practices can apply to all. “Overall, corporate governance is no longer limited to leading companies in fact many small organizations are slowly integrating these techniques to create a sound governance framework.” (Maharaj, 2011)

In a recent Corporate Governance for Small Business Report compiled by 4imprint, a company that provides in-depth, how-to articles based on research conducted by professionals and published experts who are familiar with industry trends- points out that small enterprises should start integrating corporate governance practices to best support its investors or multiple business partners.

‘It’s true that most small businesses are more concerned about viability and affordable business

solutions than they are about corruption,' the report says. 'In a free-market business culture, corporate governance practices can bring stability to markets, strengthen institutions, promote investment and weaken corruption.' (4Imprint, 2010)

According to Barbara Bowes, president of Legacy Bowes Group, a global reach and strategy firm headquartered in Canada, when a small business reaches the size of 10-20 employees its formal organization structure begins taking shape. 'You will see that more and more small businesses are developing a code of conduct together with corporate values and are listing these right on their website.' (Maharaj, 2011)

### **3. Corporate Governance Principles Adapted to the Needs of Small and Medium Businesses**

The principles and recommendations given below are to serve as a frame of reference for small and medium businesses aiming to craft internal structures of corporate governance. They are general guidelines that should be further tailored by each company to fit its own organizational structure, company culture, line of business and sources of financing.

The recommendations are divided in two groups, providing answers to the questions what to do on a company level and what to do on an individual level.

#### **3.1 What to do on a company level?**

##### **3.1.1 Have 'Tone at the Top Approach'**

The 'tone' of the top management (in the case of small companies, usually the owners) affects company culture. How top management reacts to pressures, such as meeting internal budget plans or earnings expectations, is essential. Therefore, in order to structure effective governance in small and medium businesses, top management (and the owners) should not only be clear on the long and medium term strategy and risk appetite of the company, but should also give clear signals that they unconditionally support the governance mechanisms, the policies and procedures in place including honesty, integrity, and professionalism of its employees.

### **3.1.2 Have strict, efficient and transparent policies and procedures for all areas of operation, implemented in practice**

Some of the policies and procedures that are advisable to small and medium businesses are as follows:

- Code of Conduct & Ethics (companies may also choose to have similar, but specific by-laws for the senior financial officers (such as Code of Ethics for Senior Financial Officers);
- Procedures for monitoring transactions with affiliated/connected entities (including relevant reports);
- Procedures for identifying possible conflicts of interest and acting accordingly;
- Transparency and Disclosure Procedures;
- Whistle Blowing Procedures.

Basel II<sup>1</sup> introduced a new requirement i.e. to have comprehensive, consistent and efficient stress testing. Even though Basel II applies only to banking and financial institutions, it may be useful guideline for other types of companies to also have stress testing i.e. undertake relevant analysis to ensure they are identifying and managing risks inherent in their business in accordance with sound internal risk management practices.

The issues arising from stress-testing faced by smaller businesses are different in some ways from those faced by larger, more complex businesses. “The impact of external events (e.g. adverse economic circumstances) or internal events (e.g. IT failure), and the need to ensure a proportional response for smaller companies is different. This means that the stress-testing exercises performed by smaller businesses should differ in nature from those undertaken by larger and more complex

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<sup>1</sup> Basel II is a document issued by the Basel Committee on Banking Supervision, initially published in June 2004. Its purpose was to upgrade the existing Basel I, i.e. the international standards that banking regulators were using when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks and other financial institutions face while maintaining sufficient consistency (Source: <http://www.bis.org/publ/bcbsca.htm>)

businesses.” (FSA, 2011) They should develop and implement stress testing that assesses their ability to meet capital and liquidity requirements in stressed conditions, adapted to their size and capacity. This should be accomplished by:

- setting policy for internal stress testing requirements;
- setting stress scenarios; and
- monitoring and aggregating stress test scenarios and results.

Many other policies and procedures may be implemented by small and medium businesses, depending on their type and scope of activities.

Lastly, having policies and procedures, without their proper implementation, is a waste of time and resources. Thus, small and medium businesses should also maintain proper implementation and monitoring systems.

### **3.2.3 Recruitment and Remuneration Management**

Have strict criteria, rules and processes for recruiting and remuneration of management, in its most extensive meaning (i.e. Supervisory and Management Boards, Board of Directors, CEOs, CFOs, CAOs, other persons with special rights and responsibilities).

All companies, no matter their size, should regulate the manner in which the management, in its most extensive meaning, receives remuneration and makes it known to its stakeholders.

It is recommendable to have a formal Remuneration Policy, and such Policy and its implementation procedures to be in line with the company’s culture, long-term objectives and strategy, as well as with the environment where the company operates.

For large companies it is also recommendable to have Nomination Committee and/or Governance Committee and/or Remuneration Committee, which are established to recruit new board members and other top management and to ensure that each board member is equipped with the proper tools and motivation to carry out his/her responsibilities. Also, to ensure that remuneration arrangements support the strategic aims of the business and enable recruitment, motivation and retention of top

and medium management, while complying with the requirements of regulatory and governance bodies, satisfying the expectations of shareholders and remaining consistent with the expectations of the wider population.

Due to the fact that small and medium businesses usually have modest number of employees, it may not be cost effective or prudent to have all the committees in place. However, again depending on the actual size of the company and the company boards, it may be advisable to have one of the committees in place or give the existing board members (directors) the authority to carry out the roles that would otherwise be undertaken by these committees, with obligation to exclude themselves from matters where they have personal interest.

When recruiting management, in its most extensive meaning, companies should make sure that the management:

- is appropriately qualified, knows the relevant regulations, and is able to make meaningful contributions;
- understands its role in the governance of the company;
- knows the company and its profile, and is capable to actually evaluate the company's operations;
- is honest, competent and bold to give objective opinions;
- has strong personal integrity, avoids conflict of interest;
- is able to establish and maintain professional relations and consistently and appropriately takes into account and balances the interests of all the stakeholders; and
- is able to devote enough time for active fulfilment of his/her obligations.

Size relative, thus possible issues with quality and independence of board members and decisions, small and medium businesses should try to keep at minimum (if not avoid) interlocking directorates, i.e. a practice where company board members serve on boards of multiple companies.

### **3.1.4 Have well defined responsibilities, reporting lines and accountability among all company bodies, committees and employees**

What most companies are missing in the corporate governance structure, especially small and medium companies, are well defined responsibilities, reporting lines and accountability among all company bodies, committees and employees, and appropriate monitoring of their work.

Effective corporate governance includes setting clear expectations among all the stakeholders, and an ongoing, two-way discussion between management and employees about meeting these expectations, about overall performance, priorities and challenges. One of the ways to do this is through 'a program that includes employee, management, also company bodies and committees self-appraisals. This program formalizes the two-way dialogue, avoiding top down evaluations that often serve to discourage or disengage the involved parties. It also helps to strengthen this vital two-way dialogue in the company's management culture.' (Halogen Software, 2001)

Therefore, depending on the organizational structure of the company, it is recommendable to have self-evaluations performed, by all of the above stated stakeholders. Moreover, the results of the self-evaluations should not be overlooked and marginalized, but should be employed as best as possible to the benefit of the company.

### **3.1.5 Have professional and independent Internal Audit Department and Independent External Auditor**

The management in its most extensive meaning (in small companies also the owners) have the ultimate responsibility for the design, implementation, and monitoring of the internal control and audit environment and for adequate (meaning objective and independent) external audit.

Strong, qualified and independent internal audit is an absolute must. It assists a business in accomplishing its objectives, by bringing a systemic, disciplined approach to evaluate and improve the effectiveness or risk management, control, and governance processes. Therefore, the management and the owners should assure that the company has a system in place that allows the

internal audit to conduct objective and independent analysis and provide constructive opinions or recommendations.

Even though most of the small and medium businesses, depending on the actual size and country of origin<sup>1</sup>, do not have legal obligation to provide an external review of the company's financial statements, an external audit can offer some advantages, such as: identifying weaknesses in internal controls, lending credibility to the financial statements, as financial statements that have been audited and verified by an external auditor are considered more reliable than those that have not, and giving unbiased, expert recommendations.

Therefore, it is advisable even for small and medium businesses, to not only have external auditor, but also to ensure that the external auditor is independent of management in fact and appearance when providing its services. It is also necessary to make sure that the "external auditor provides timely information to the relevant company instances about important accounting practices and policies adopted by management and any discussion or disagreement between the auditor and the management about alternative practices or policies.

There are certain services which external auditors are legally prohibited to provide simultaneously with providing audit services, and these include: bookkeeping or other services relating to the accounting records or financial statements, financial information systems design and implementation, appraisal or evaluation services, fairness opinions or contribution-in-kind reports, actuarial services, internal audit outsourcing services, management or human resources functions, broker or dealer, investment advisor, or investment banking services, legal services and expert services unrelated to the audit, and any other service prohibited by law." (Summary of Sarbanes-Oxley Act, 2002)

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<sup>1</sup> For example, according to Macedonian Company Law (Official Gazette of RM No. 28/04, 84/05, 25/07, 87/08, 42/10, 48/10 and 24/11) the following entities are subject to external audit:

1. Large and medium joint stock companies;
2. Companies, the shares of which are listed on the stock exchange; and
3. Large and medium limited liability companies.

### 3.1.6 Audit Committee

Large companies practicing good corporate governance commonly establish special governance body i.e. Audit Committee, focusing mainly in three areas: financial reporting, risk management, and internal and external control. This is a requirement and not an option for listed companies.

International best practices suggest that Audit Committees should develop and maintain an internal document, for example an ‘Governance Committee Charter’ (Ampco- Pittsburgh Corporation, 2004), or Audit Committee Charter’ which addresses its purpose, duties, and responsibilities. The New York Stock Exchange (NYSE) has a similar view on this, suggesting that the Charter should include provisions as follows:

- “The purpose of the Audit Committee, which is to assist the supervisory function in overseeing the integrity of company’s financial statements; company’s compliance with legal and regulatory requirements; independent auditor’s qualifications and independence; and the performance of the company’s internal audit function;
- The duties and responsibilities of the Audit Committee, which are to: at least once annually, obtain and review the independent auditor’s report; discuss the audited annual financial statements and the quarterly financial statements with the management and the independent auditor; discuss press releases that disclose company’s earnings, as well as financial information on company’s earnings provided to analysts and rating agencies; as appropriate, provide advice and assistance from external legal, accounting, and other advisors; discuss policies with respect to risk assessment and risk management; hold separate meetings with management, internal auditors, and independent auditors, at least once quarterly; review, together with the external auditor, the problems or difficulties that might have arisen during the audit, and the management’s response to them; prepare reports (if required)”. (IFC, 2007)

In view of all of the above, it is recommendable for small and medium businesses to take into consideration the option of having an Audit Committee, consequently decide on whether and when to establish the same, and which authorizations and duties to assign to it.

### **3.1.7 Work Transparently**

Working transparently means disclosing information that allows market participants to make an informed assessment of the company's financial position and performance, risk exposure, risk management practices and business strategy. "It can be achieved only if the published information is timely, relevant, comprehensive, comparable and based on sound measurement principles that are applied consistently." (Deutsche Bundesbank, 2005)

Information disclosure provides investors with knowledge needed for making informed investment decisions. The information is usually disclosed in annual, semi-annual, quarterly, and other company reports, as well as within the framework of other reporting requirements. In addition to enhancing trust, disclosure increases the overall market efficiency as well. "Transparency and disclosure are not synonyms." (IFC, 2007)

While companies may disclose an enormous amount of information, if the disclosed information has no particular value to the investors, and some important pieces of information are withheld or misrepresented, companies may still be considered not transparent.

Transparency and disclosure are essential for sound corporate governance. Most of the accounting scandals that happened in the past were partly due to inappropriate disclosure. Although lack of transparency is usually linked to insufficient information provided to the employees and the public, it is interesting to note the "2007-2010 financial crisis can be to an important extent attributed to lack of systematic procedures for centralizing and escalating red flags to the appropriate level in a company and the risk exposure information not reaching the board and senior levels of management." (Kirkpatrick, 2008)

In view of the above, irrespective of their size, companies should establish effective channels of transmission of information. They should have systems in place to assure that correct, timely, relevant, comprehensive, comparable information is shared not only externally, but also internally, across the company and upwards to the management. One way to do this is through a Disclosure Policy and a system of information verification and monitoring of the implementation of the Disclosure Policy.

### **3.1.8 Work on Communication, Trainings, Motivation**

Elements of a sound corporate governance system are efficient communication, continuous education of management, committee members and employees as well as innovative planning. Through orientation programs for new managers, committee members and employees as well as continuing education programs, companies should make assure that all relevant constituencies acquire appropriate skills upon appointment, and thereafter remains abreast of relevant laws, regulations, company developments and changing risks.

Even though many small and medium businesses overlook the importance of succession planning, many of them experience leadership vacuum during critical times, whether through retirement, promotion or staff attrition. To avoid this, companies need to “develop a written job description for the leadership positions, identify the pool of potential talents, and recognize the specific leadership positions that are important to business’s productive operation, write management succession plan, and commit to it by formally communicating the plan throughout the company.” (Malik Sharrieff, 2011)

### **3.2. What to do on an individual level?**

As to the recommendations that may be given to the management and the owners of small and medium businesses, they certainly are many and depend on a lot of different factors. However, some of the common, internationally accepted recommendations are:

- Be aware that the liabilities and sanctions are significant;

- Be aware that things should be done in action and not only on paper;
- Ask for sufficient time to view the documents;
- Be aware of last minute changes in documents, information, etc, or last minute items added on a meeting agendas;
- Consult;
- Take time to read and prepare;
- Don't be afraid and embarrassed to ask questions and explanations of the presented data; and
- Ask additional information and reports (tailored to your understanding).

#### **4. Conclusion**

What is quite important and significant to the future sustainable growth of companies, is the tendency of smaller companies accepting the good governance principle and looking for expert support on the matter. The interest is evident both from the side of the management, employees and external parties.

“Importantly, our efforts will also help develop a culture of values for professional and ethical behaviour on which well functioning markets depend. Trust and integrity play an essential role in economic life and for the sake of business and future prosperity we have to make sure that they are properly rewarded.” – said Donald J. Johnston, OECD Secretary-General in his forward addressing within the publication on Principles of Corporate Governance. (OECD, 2004)

**Abstract:** Corporate governance refers to a set of internal policies, rules, and procedures that a company follows on a regular basis to ensure that it operates in a fair, equitable, and appropriate manner for the benefit of the company, its management and its stakeholders. It is almost always thought about in the context of big publically listed companies. However, it is just as important for privately held, small and medium sized businesses to adhere to good corporate governance policies

and practices. One of the reasons being their accountability, as key economic drivers and job creators in most of the countries. As businesses grow and stakeholders increase, good corporate governance becomes even more important, as there are many people with vested interests. Yet many small and medium businesses do not necessarily pay attention to the concepts of corporate governance. Most of them do not even have the necessary structure and knowledge to shape and promote it.

This Paper discusses how corporate governance applies to small and medium businesses. It explains the mechanisms related to sound corporate governance in big companies, such as well developed and implemented policies, procedures and processes, risk management systems, strategic planning, transparency and disclosure, etc. and recommends which of these mechanisms may be applicable and effective for small and medium businesses.

As a final note, having discussed all of the above, the Paper shall conclude that every company, no matter what size it is, will see the positive effects of implementing the principles of corporate governance.

**Key words:** corporate governance, corporate culture, SMEs

**JEL Classification:** G34; M14; D01;

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