

“The German corporate governance code and its adoption by listed SMEs – just another ‘Procrustes bed’?”

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## SECTION 2. Management in firms and organizations

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### The German corporate governance code and its adoption by listed SMEs – just another ‘Procrustes bed’?<sup>1</sup>

#### Abstract

The discussion of companies’ compliance with corporate governance standards and codes has widely neglected the situation of small and medium-sized enterprises (SMEs). Accordingly, the authors examine a sample of 151 SMEs listed on the Frankfurt Stock Exchange in 2006 (before the financial crisis) and 2012 (after the financial crisis) and, thus, required to declare whether they comply with the recommendations of the German Corporate Governance Code or not. While code compliance seems to be quite homogenous comparing different branches, the authors found that company size has a positive impact on code compliance. With regard to a remarkably high number of recommendations a lot of companies do not comply to, company size might be a major problem, why the existing GCGC does not fit very well to the situation of SMEs. This is why, most remarkably, code compliance does not exert any significant influence on either market reaction or on operating performance of SMEs.

**Keywords:** corporate governance, SMEs, Germany, firm performance.

**JEL Classification:** G3, G34, M10, L25.

#### Introduction

In recent years, corporate governance has become one of the key issues of both management research and practitioners (Keasey et al., 1999; Lazzari et al., 2001). This was particularly the case following several cases of firm crisis and management misconduct (for example, Enron, Parmalat). However, most of the time, this discussion concentrates on large corporations, thus, neglecting the numerous small and medium-sized enterprises (SMEs) (Cravens and Wallace, 2001). This is particularly true for the situation in Germany, where it is widely debated whether and to what extent the topic of corporate governance is in keeping with the particular legal and economic status of SMEs (e.g., Bernhardt, 2003; Claussen and Bröcker, 2002; Steger, 2006; Strenger, 2003). One could even argue that a “Procrustes bed” phenomenon exists here.

This marks the starting point of our paper. Since German law (§161 German Corporation Act) requires each listed company to declare whether it complies with the recommendations of the German Corporate Governance Code (GCGC) or not, we decided to focus on those SMEs that are incorporated as joint-stock companies and are listed on the Frankfurt Stock Exchange. Drawing on data from about 151 SMEs in 2006 (before the financial crisis) and 2012 (after the financial crisis), we explore to what extent these companies were in line with the existing standards of

“good” corporate governance, (if) something has changed over time and what reasons may influence this. Furthermore, we test whether being in line with the code’s recommendations has any valuation and performance effects for these companies. We then formulate four propositions to identify the main problems in this context and to devise potential measures to improve the situation.

#### 1. Theoretical perspectives

With respect to corporate governance aspects, *agency theory* is certainly the most frequently used approach (Dühnfort et al., 2008). It proposes that adequate monitoring or control mechanisms need to be established in companies in order to protect shareholders and other investors (Shleifer and Vishny, 1997). Effectively structured boards, up-to-date accounting practices, and a transparent information policy exemplify internal mechanisms that encourage the active monitoring of the managerial decision making processes (Kiel and Nicholson, 2003). The benefits of sound and effective corporate governance mechanisms are expected to outweigh the costs (Parsa et al., 2007). Accordingly, all corporations, whether large or small, are well advised to follow and comply with the standards of “good” corporate governance formulated in codes of best practice (Bartholomeusz and Tanewski, 2006). Code compliance, moreover, can also be considered a means of signaling a high level of corporate governance quality to investors, analysts, as well as to the wider public (Stiglbauer, 2010). Conversely, it is not surprising that these codes tend to be dominated by an agency theory perspective (Zattoni and Cuomo, 2010).

Shankman (1999) challenges agency theory’s (limited) focus on investors and proposes *stakeholder theory* as an alternative perspective where different

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<sup>1</sup> In Greek mythology, *Procrustes* was a bandit who physically attacked people, stretching them, or cutting off their legs so as to make them fit the length of an iron bed.

stakeholder groups are recognized and considered. Against this background, Heath and Norman (2004) suggest that there is a need for reforms in corporate governance mechanisms, whereby regulatory codes and requirements formally consider the interests of non-shareholding stakeholders. However, existing corporate governance regulatory codes usually do not explicitly relate to non-shareholding stakeholders (Parsa et al., 2007). For instance, although German corporate governance is well-known internationally for its employee co-determination and strong workers' representation on supervisory boards, problems and aspects associated with it are hardly mentioned in the GCGC.

A few authors recently proposed *institutional theory* as an adequate approach for examining code compliance. Hooghiemstra et al. (2008) argue that companies are 'isomorphic' as to their (non)compliance with corporate governance codes, as well as the arguments they offer for non-compliance with the provisions contained in corporate governance codes (similar Spira and Page, 2010). The highly institutionalized environment of companies provides "a context in which individual efforts to deal rationally with uncertainty and constraints often lead, in the aggregate, to homogeneity in structure, culture, and output" (DiMaggio and Powell, 1983, p. 147). By recommending a comprehensive set of norms, corporate governance codes have become part of this institutional environment in which listed companies operate (Aguilera and Cuervo-Cazurra, 2004; Broberg et al., 2010; Seidl, 2007). However, it seems questionable whether this provides an adequate description of the situation of listed SMEs as well. Their environment must be considered much less institutionalized, compared to that of large corporations and the public scrutiny and pressure resulting from investors' and analysts' expectations is much less developed here. This might also be supported by the fact that SMEs are often mainly financed via debt and not via equity (Citigate Dewe Rogerson, 2010). Moreover, the area of SMEs is usually characterized by a large heterogeneity of companies and company strategies (Bernhardt, 2003; Pennings and Garcia, 2004; Winkeljohann and Kellersmann, 2006).

## 2. German SMEs and the GCGC

**2.1. Development of the GCGC.** Although some initiatives to fix principles for "good" corporate governance were launched during the 1990s (for example, Von Werder, 1996), they were poorly reflected in company practice and public opinion. In the aftermath of the publication of the OECD principles of corporate governance (OECD, 1999), a few diverse expert groups based on private and political initiatives started to consider respective regularities in Germany. The collapse of the internet

bubble and the subsequent downward spiral even catalyzed these activities.

In January 2000, the Frankfurt Commission published its principles, while the Berlin Commission and the first corporate governance scorecard (DVFA) followed suit in June. At the same time, the federal government appointed a commission (Baums Commission), which accomplished their task in July 2001. Among numerous recommendations, the commission demanded a combined code of best practice. Consequently, the Federal Minister of Justice appointed a second governmental commission (Cromme Commission), which formulated the German Corporate Governance Code in February 2002 (Cromme, 2002). The code's principles can be divided into three groups (Von Werder, 2002):

- a) Prescriptions derived from existing law and, therefore, mandatory for all joint-stock companies.
- b) Recommendations that each listed company is obliged by §161 German Corporation Act to declare in its annual report whether it has complied or not. However, the companies are not forced to explain the reasons in case of non-compliance.
- c) Suggestions as to what the code commission considers to be "good" corporate governance. They are by no means binding for the companies, but, nevertheless, important, since they often represent advances in national, as well as international corporate governance best practices.

**2.2. Implementation of the code.** The results of this process have been fairly ambiguous. On the one hand, the implementation of the code among large corporations has advanced rather satisfactorily (Von Werder et al., 2006). Nevertheless, it was questioned whether and how far code compliance really does mirror "good" corporate governance practice. Theisen and Raßhofer (2007) argue that "good" corporate governance must be lived rather than just declared. Von Werder and Talaulicar (2008) mention that a company may give good reasons for not complying, which reflects a positive, critical self-reflection of its own corporate governance. Several authors did, indeed, report some slight indicators for a change of key corporate governance practices in Germany. They witnessed an increase in the legal protection of minority shareholders, the evolution of more offensive takeover regulation, and a reconsideration of their monitoring approach among major blockholders (Beyer and Hassel, 2002; Cromme, 2005; Hackethal et al., 2005). The assumption, however, that compliance with standards of "good" corporate governance would have a positive effect on company valuation (e.g., Goncharov et al., 2006; McKinsey, 2000) has been rejected by several recent studies (Bassen et al., 2009; Nowak et al., 2004; Stiglbauer, 2010).

On the other hand, if we focus on listed SMEs, the level of implementation of the code is still much more problematic. Although there has never been a study focusing specifically on listed German SMEs, several authors have explored the code compliance behavior of companies that do not belong to one of the four main indices (Dax, MDax, TecDax, SDax). While Nowak et al. (2004) found an average of only 4.7 rejected recommendations, Ergo (2003) found 6.5, and Von Werder et al. (2005) found 7.2. Alongside the methodological problems in comparing these different findings (for example, different numbers of recommendations, different numbers of companies), they all point out clearly that the degree of code compliance is significantly lower among these companies compared to those belonging to the major indices. Experts concluded that this was primarily due to firm size, amount of capital market orientation, and the relatively high implementation costs of these companies (Ergo, 2003; Von Werder et al., 2006). Moreover, some specific corporate governance structures of SMEs – for example, lower level of formalism, distinctive long-term orientation, or stronger personal interlinks – may also play a role (Bernhardt, 2003; Dörner and Wader, 2005). Nevertheless, it was clearly stated that further research is necessary to explore and test the reasons for different patterns of SME code compliance, as well as its impact on company performance (Von Werder et al., 2005).

### 3. Methods

Among the 644 companies listed on the Frankfurt Stock Exchange in June 2006, 378 exceeded the limits we defined for SMEs – maximum annual turnover of 50m €, maximum staff of 500. Some further 52 companies declared insolvency just before or during our study. 63 companies displayed insufficient information (for example, no declaration was available concerning on the GCGC rules). This resulted in 151 companies being included in our sample for 2006, respectively, 92 companies for 2012 (we've lost 59 companies from 2006 to 2012 due to missing values, delisting, bankruptcy or mergers with other companies).

Since the previous studies on code compliance differ significantly amongst each other with regard to the number of recommendations observed, we decided to do a systematic analysis of the GCGC, evaluating each sentence for the term “shall”, which is generally an indication of a recommendation. As a result, we found 82 recommendations in the GCGC version of June 2005 and 92 recommendations in the GCGC version of June 2011.

Using content analysis, we analyzed the compliance statements in the company business reports from 2006 and 2012, which display the reaction of the SMEs against the recommendations of the most current version of the GCGC. All rules were weighted equally (fulfilling a recommendation: 1; not fulfilling: 0), which results in a potential maximum score of 82 (2006), respectively, 92 (2012). Moreover, we differentiated these scores according to the GCGC's main subcategories, namely shareholders/general meeting, cooperation between management board/supervisory board, management board, supervisory board, transparency, and reporting/audit (Von Werder et al., 2006) in order to get a more precise picture of the impact of different corporate governance issues on performance.

### 4. Findings

**4.1. Overview.** As expected, the general level of code compliance is relatively low among the SMEs. On average, 15.8 recommendations (2006), respectively, 25.5 (2012) were rejected; that is, a compliance rate of 80.1 percent (2006), respectively, 73.4 (2012). This is fairly in line with previous studies (for example, 74.1 percent – Von Werder et al., 2006) in similar samples. There was no company complying with all recommendations.

**4.2. Branch.** A first aspect observed was the branch affiliation of the companies. Here, one can expect the companies in highly regulated branches, for example, financial services, to comply better with the code. Akhigbe and Martin (2006), for instance, found a higher proportion of implementing the Sarbanes Oxley Act within financial services companies to be a factor of success. Galli (2005) reported similar findings with respect to the Italian financial services industry. We based our analysis on the sector scheme proposed by OnVista Online. In order to make comparisons feasible, we deduced seven larger groups, namely, Software, IT/Internet, Media, Technology, Healthcare, Financial Services and Others. The results are displayed in Table 1.

It becomes obvious that branches dealing with “new technologies” perform best here, whereas media companies have the lowest compliance rates. Interestingly, and in sharp opposition to the assumptions above, financial services companies have a rejection rate considerably above the average. In general, however, the medians of the different samples are fairly similar, and the standard deviations of the financial services sample and of the media sample are rather high. This leads us to assume that the higher rejection rates are due to a limited number of “extreme cases” with full rejection of the code.

Table 1. Code compliance in different branches

| Branch             | Companies |      | Compliance rate (in percent) |      | Median (in percent) |      | Standard deviation |      |
|--------------------|-----------|------|------------------------------|------|---------------------|------|--------------------|------|
|                    | 2006      | 2012 | 2006                         | 2012 | 2006                | 2012 | 2006               | 2012 |
| IT/Internet        | 28        | 17   | 84.2                         | 72.3 | 87.8                | 72.9 | 9.5                | 14.6 |
| Software           | 31        | 15   | 83.2                         | 73.9 | 86.6                | 76.0 | 16.3               | 11.2 |
| Healthcare         | 19        | 14   | 83.2                         | 79.3 | 87.5                | 82.8 | 20.4               | 14.7 |
| Technology         | 22        | 10   | 80.2                         | 78.3 | 86.6                | 79.7 | 19.3               | 14.1 |
| Others             | 15        | 18   | 78.3                         | 72.0 | 84.7                | 68.2 | 22.1               | 13.5 |
| Financial services | 18        | 10   | 76.5                         | 67.0 | 85.4                | 63.0 | 27.5               | 22.4 |
| Media              | 18        | 8    | 69.9                         | 76.8 | 83.7                | 76.0 | 32.1               | 11.7 |
| Total              | 151       | 92   | 80.1                         | 74.0 | 86.6                | 75.5 | 21.5               | 15.2 |

**4.3. Size.** Given the fact that compliance with the GCGC also results in considerable costs for the companies that are regressive in nature (Chittenden et al., 2005; Nijssen et al., 2009), one can expect companies with relatively lower compliance costs (in relation to the annual revenue) to also show a higher compliance rate

(Broberg et al., 2010; Eierle, 2008). The average annual revenue of the companies observed is 19.7m € (standard deviation: 13.7), the average number of employees is 121 (standard deviation: 101). Table 2 displays the code compliance of different groups regarding the number of employees.

Table 2. Code compliance according to firm size (number of employees)

| Number of employees | Number of companies |      | Compliance rate (in percent) |      | Median (in percent) |      | Standard deviation |      |
|---------------------|---------------------|------|------------------------------|------|---------------------|------|--------------------|------|
|                     | 2006                | 2012 | 2006                         | 2012 | 2006                | 2012 | 2006               | 2012 |
| < 50 employees      | 45                  | 29   | 75.9                         | 69.7 | 84.1                | 67.7 | 25.6               | 18.8 |
| < 150 employees     | 57                  | 22   | 78.1                         | 75.0 | 86.6                | 76.0 | 25.3               | 14.3 |
| > 150 employees     | 49                  | 39   | 86.2                         | 75.3 | 87.8                | 80.2 | 6.7                | 11.8 |

The number of employees and code compliance seem to be clearly connected. This is further stressed by the fact that a significant correlation of .21 (2006) ( $p < .05$ ), respectively, .27 (2012) ( $p < .05$ ) could be found between them.

**4.4. Critical recommendations.** Taking into consideration the critical recommendations, namely those rejected by more than 10 percent of the companies (Von Werder et al., 2005), nearly half of

them (40 out of 82, 2006) and more than half of them (57 out of 92, 2012) are found to belong to this group. To analyze each of them in detail would go beyond the limited size of this paper. So we decided to focus particularly here on those recommendations rejected by more than 50 percent of all SMEs either in both years 2006 and 2012 or only in one year 2006 or 2012. This resulted in five most critical recommendations (see Table 3).

Table 3. Five most critical recommendations of SME code compliance

| Code paragraph              | Content   | Rejections |      | Rejection rate (in percent) |      |
|-----------------------------|---|------------|------|-----------------------------|------|
|                             |   | 2006       | 2012 | 2006                        | 2012 |
| 3.8                         | Deductible for the management board in the Directors and Officers' liability insurance                        | 92         | 63   | 60.9                        | 68.5 |
| 4.2.4 (Phrase 2)            | Transparency of individual salaries of management board members   | 86         | 0    | 57.0                        | 0    |
| 5.3.3                       | Introduction of nomination committee on the supervisory board   | n.a.       | 74   | n.a.                        | 80.4 |
| 5.4.1 Section 2             | Specification of concrete objectives with regard on diversity, age, independence of supervisory board members | n.a.       | 61   | n.a.                        | 66.3 |
| 5.4.7 (Section 2, Phrase 1) | Inclusion of performance oriented aspects in the compensation of the supervisory board members                | 96         | 6    | 63.6                        | 6.52 |

Consequently, we need to explore more closely the explanations given by the respective companies (see Table 4). As the Cadbury Committee (1992) puts it,

smaller firms might have difficulty complying with some aspects of the code, but should still provide some (good) reasons for non-compliance.

Table 4. Explanations given regarding five most critical code recommendations

| Code paragraph | Explanations given by the companies   | (in percent)                      |                                    |
|----------------|---|-----------------------------------|------------------------------------|
|                |   | 2006                              | 2012                               |
| 3.8            | <ul style="list-style-type: none"> <li>- No real negative incentive</li> <li>- Salaries of board members are too low</li> <li>- Recruitment problem with board members</li> <li>- Other explanations</li> <li>- No explanation</li> </ul> | 26.1<br>5.4<br>2.2<br>9.8<br>56.5 | 63.5<br>28.6<br>4.8<br>19.0<br>9.5 |

Table 4 (cont.). Explanations given regarding five most critical code recommendations

| Code paragraph              | Explanations given by the companies   | (in percent) |      |
|-----------------------------|---|--------------|------|
|                             |   | 2006         | 2012 |
| 4.2.4 (Phrase 2)            | - Violation of personality rights   | 11.6         | -    |
|                             | - Individual salaries may be calculated on the basis of the information given | 4.7          | -    |
|                             | - Worthless information for shareholders                                      | 3.5          | -    |
|                             | - Other explanations  | 2.3          | -    |
|                             | - No explanation  | 77.9         | -    |
| 5.3.3                       | - Size of audit committee   | -            | 90.9 |
|                             | - Task responsibility by whole audit committee                                | -            | 26.0 |
|                             | - Size of company   | -            | 19.5 |
|                             | - No added efficiency   | -            | 7.8  |
|                             | - Other explanations  | -            | 10.4 |
| 5.4.1 Section 2             | - Focus on professional and personal qualification                            | -            | 63.9 |
|                             | - Consideration of diversity  | -            | 29.5 |
|                             | - Other explanation   | -            | 52.5 |
|                             | - Size of audit committee   | -            | 23.0 |
|                             | - No explanation  | -            | 4.9  |
| 5.4.7 (Section 2, Phrase 1) | - No real positive incentive  | 8.3          | -    |
|                             | - Increase of remuneration costs  | 8.3          | -    |
|                             | - Endangers the supervisory board members' independency                       | 5.2          | -    |
|                             | - Other explanations  | 5.2          | -    |
|                             | - No explanation  | 72.9         | -    |

First of all, it is somewhat surprising to learn that (against international standards: see, e.g., the Cadbury Report) a majority of the companies do not explain their rejections in 2006 (until 2009, this was not mandatory for German corporations and they did not voluntarily). The reasons given regarding paragraph 5.4.7 (Section 2, Phrase 1) are hardly convincing and do not reflect the current knowledge in this field. Regarding Paragraph 3.8, again, most explanations are fairly weak and less sophisticated. The same can be said about the explanations given with respect to the recommendation of Paragraph 4.2.4 (Phrase 2). The reference to the violation of the board members' personality rights is of certain value. However, the Act Regarding the Disclosure of Management Board's Remuneration (VorstOG), introduced by the German legislator in 2006, has provided a legal basis in this respect and, consequently, has turned this recommendation into a legal requirement (thus, no option for rejection).

Moreover, it should be noted here that the latter three critical recommendations were also identified to be neuralgic among larger listed companies in earlier studies (e.g., Von Werder et al., 2006). So, the code compliance behavior of the SMEs observed here mirrors some

problematic aspects of the German corporate governance in general, even on a more accentuated level.

**4.5. Market reaction and effects on operating performance.** Last but not least, we examine whether and how far the stock markets may benefit or punish SMEs in reaction to their code compliance and whether "good" corporate governance (high levels of compliance with the GCGC) effects operating performance, by reducing agency costs (Stiglzbauer, 2010). This is even more interesting when taking into account the heterogeneous results of earlier studies regarding this question among large companies (for example, Bassen et al., 2009; Goncharov et al., 2006).

We calculated two performance measures: one that covers operating performance (return on equity - ROE) and one that covers capital market performance (stock price development - SPD). Within a sample of 139 companies for 2006 (reduced from 151 due to missing values), respectively, 92 companies for 2012, we did not find any significant correlation in this respect (Table 5). Even when differentiated with respect to the GCGC's subcategories (SC1-SC6), there are no statistically significant effects. Declared compliance with the GCGC obviously does not function as a value-driver or as a driver for operating performance for German SMEs.

Table 5. Impact of compliance on operating performance and stock price development

|     |                         | Degree of code compliance |        |       |        |       |        |       |        |       |        |       |        |      |       |
|-----|-------------------------|---------------------------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|--------|------|-------|
|     |                         | Total                     |        | SC1   |        | SC2   |        | SC3   |        | SC4   |        | SC5   |        | SC6  |       |
|     |                         | 2006                      | 2012   | 2006  | 2012   | 2006  | 2012   | 2006  | 2012   | 2006  | 2012   | 2006  | 2012   | 2006 | 2012  |
| ROE | Pearson correlation     | -.031                     | -0.043 | -.024 | -0.060 | -.015 | -0.113 | -.067 | -0.033 | -.034 | -0.021 | -.026 | -0.047 | .011 | -0.06 |
|     | Significance (2-tailed) | .721                      | 0.69   | .778  | 0.57   | .856  | 0.28   | .431  | 0.75   | .690  | 0.84   | .761  | 0.66   | .900 | 0.57  |
| SPD | Pearson correlation     | .021                      | 0.059  | .053  | 0.049  | .032  | 0.108  | -.051 | -0.044 | .069  | 0.089  | .072  | 0.064  | .062 | 0.049 |
|     | Significance (2-tailed) | .804                      | 0.57   | .537  | 0.64   | .708  | 0.30   | .553  | 0.68   | .417  | 0.40   | .399  | 0.55   | .465 | 0.64  |

SC1: Shareholders and general meeting; SC2: Relationship between management board and supervisory board, SC3: Management board, SC4: Supervisory board, SC5: Transparency, SC6: Reporting and audit.

## 5. Propositions

To sum up the findings of our research, we put forward four propositions:

*Proposition 1: The compliance with the GCGC among listed SMEs must be considered problematic. However, common explanations obviously fail to rationalize this situation.*

In line with earlier studies in this field, German listed SMEs do differ considerably from larger enterprises with respect to their code compliance behavior (e.g., Ergo, 2003; Von Werder et al., 2006). The SMEs examined by this study only showed an average compliance rate of 80.1 percent (2006) and 73.4 (2012), respectively. Given that the GCGC is dedicated to all listed companies, a significantly lower compliance rate among listed SMEs must be considered problematic and should not be neglected.

This point is even stressed by the fact that short-handed explanations obviously run short. Questions of size or cost problems are usually said to be the basis of this situation (Ergo, 2003; Von Werder et al., 2006). As demonstrated above, these points cannot be denied; however, they do not explain the whole story. Two additional aspects need to be mentioned: first, although listed SMEs constitute a particular share of all SMEs, our analysis highlighted several problems that obviously mirror a range of earlier criticisms of corporate governance in German SMEs in general. We even note a strong sense of autarky in SMEs, with the entrepreneur feeling like the “master in house”; a widespread deficit of controlling and risk management institutions inside of the firm; or a problematic attitude towards transparency (Becker et al., 2009; Steger, 2006; Vitols, 2001). Second, the stock exchange segment might play a certain role, with roundabout 50 percent of the SMEs in our sample being listed in the General Standard segment. The Prime Standard segment has some stricter rules on transparency and disclosure and a higher analysts’ coverage of these firms.

*Proposition 2: SMEs are not only critical with respect to code compliance. SMEs’ corporate governance in general seems to be on the verge of entering a vicious circle.*

SMEs must be considered a particular problem group. Given the limited public confidence and, thus, their limited reputation, a (veritable) ignorance of the code’s recommendations among these companies and an increase in increasingly problematic firms in this

field can easily result in a vicious circle. Both institutional investors and private shareholders still have the collapse of the Frankfurt New Market in 2002/2003 in mind. This situation is even stressed by a growing international demand for “good” corporate governance in general and the increasing pressure executed by banks with respect to the equity capital requirements of Basel II in particular (Dörner and Wader, 2005; Steger, 2006). Consequently, the pressure on listed SMEs will continue to increase in the future (Strenger, 2003). Numerous delistings from 2006 to 2012 within our sample might be a first hint confirming such an argument.

Thus, increasing transparency could play a major role for these companies. In view of the results of Section 5.4, they should give at least some explanations for not complying with specific rules. Otherwise, analysts could interpret missing explanations as bad news (Grossman, 1981; Milgrom, 1981). This could become a useful practice as long as a SME-specific corporate governance code does not exist in Germany.

*Proposition 3: The problematic code compliance behavior of listed SMEs incites considerable pressure for action by the responsible institutions. Herein, they are faced with a particular regulative dilemma.*

There is no question that the code compliance behavior described above calls for action. This addresses, first of all, the responsible institutions, namely, the Frankfurt Stock Exchange authority. As our findings demonstrated, a change of mind with respect to “good” corporate governance behavior (including transparency) has obviously not yet taken place among German SMEs on a voluntary basis. There is still a long way to go to increase the market-orientation of the German system in order to strengthen trust in German listed SMEs, because “timely and accurate disclosure of information regarding the governance of the company ... improves common understanding of the structure, activities and policies of an organization. Consequently, the organization is able to attract investors” (Junarso, 2006, p. 4).

Indeed, this change of mind is easier said than done. It must be noted that a veritable dilemma exists, depending on what reason is perceived to be the source of the present problem: on the one hand, our results can be taken as a clear indicator of a widespread deficit of “good” corporate governance among listed SMEs, as described by the GCGC Commission. In this respect, stock exchange authorities would be forced to take concrete action. Namely, they could engage in more strict controls regarding corporate governance (for example, companies that do not issue any code compliance declaration or hide it from the public). This would also include some regular evaluation and documentation of the corporate governance behavior

in general, as well as the code compliance in particular of these companies, similar to what is usually done with respect to larger corporations.

On the other hand, one could argue that our results show that the GCGC is only weakly adapted to the particular characteristics and situation of listed SMEs (the Procrustes bed phenomenon!). SMEs' code compliance behavior could, then, be excused by referring to misleading or even badly fitting code requirements. This would prevent the stock exchange authorities from taking direct action against SMEs complying poorly. However, it would (re-) open the discussion about self-regulation and the development of an alternative code for SMEs, as proposed by several authors in the past (for example, Anderson and Russell, 2011; Steger, 2006; Strenger, 2003, 2004; Uhlaner et al., 2007).

It seems clear that listed SMEs and their lobbying institutions will hardly agree with either of these proposals (Bernhardt, 2003; Steger and Hartz, 2006). This may cause stock exchange authorities to remain inactive and to wait for better times to come. However, "the simple fact that businesses are complaining about regulations is not a sufficient argument to skip regulation, because of the necessity to safeguard the related public goals" (Nijsen et al., 2009, p. 9). Moreover, conserving the current situation would also mean risking being trapped sooner or later by an increase of corporate scandals in the field of listed SMEs and/or by other institutions (for example, the state government) taking action.

*Proposition 4: SMEs are well advised to behave more reflectively and critically towards any general codes of conduct and to run a more firm-specific adoption of single rules.*

Our results contrast sharply with some theoretical assumptions about the performance-relevance of code compliance. Several recent corporate scandals in companies with high levels of code compliance (for example, Siemens, MAN) have constituted a veritable gap between declared "good" corporate governance and real action in companies, and must be considered a negative signal for the capital market (Wade et al., 1997). Consequently, investors seem to increasingly distrust high levels of code compliance. Even well governed companies suffer accordingly from analysts monitoring and searching for information more intensely, which raises their monitoring and information costs. Moreover, following agency theory and efficient market hypothesis, "stock prices change, when information changes" (Mankiw, 2008, p. 607). This could explain why even companies with a stable high level of code compliance do not witness a significant increase of operating performance or of stock price.

In this situation, low-rated companies in particular should enhance their governance mechanisms to be able to signal "good" corporate governance. Our findings show that the GCGC is not yet a widely-adopted instrument of regulation in German SMEs. This non-usage of the potential to differentiate themselves from other companies through mandatory disclosure on the GCGC rules also encouraged the German government to establish the "comply or explain" principle on GCGC recommendations in 2009. At the time of our study, companies only had to declare whether they reject a single rule, without explaining why. A new paragraph (§289a) in German trade law now also forces corporations to increase their reporting on corporate governance-specific issues. Thus, corporate governance is increasingly becoming an important task for auditors.

We can assume that auditors and companies will have to co-operate more intensively and use a more process-based approach to fulfill the new rules. So it could be worth reporting on "good" corporate governance in order to raise a company's value and to increase its potential to acquire cheaper money (Dörner and Wader, 2005). In this respect, SMEs may also consider corporate governance reporting and hence the GCGC, less as a cost factor, but as a means of signaling to investors the high quality of management and, thus, of enhancing investor trust (Collewaert and Fassin, 2013; Parsa et al., 2007). This strategy was already found to be a factor of success in several other West European countries (Chahine and Filatotchev, 2008; MacNeil and Li, 2006).

But the German legislator and the Code Commission should also think of more specific rules with enough potential for single companies to differentiate themselves from other companies, because "it is in the accounting for intangibles that the present system fails most seriously to reflect enterprise value and performance" (Lev and Zarowin, 1999, p. 354). Our findings suggest that, from an investors' perspective, reporting on "good" corporate governance does not just require a mere box ticking exercise, but rather a real change in the corporate governance of German SMEs (Stiglbauer, 2010).

## Conclusions

Differences in the degree of compliance of German SMEs with the GCGC were found to be based on different factors. First of all, we could confirm that size (measured by the number of employees) has an impact on compliance rates: the larger the companies, the higher the compliance rates are towards the GCGC. Meanwhile and contrary to other scholars (e.g., Birt et al., 2006; Hayes and Lundholm, 1996), we did not find any significant differences in code compliance across different branches. Moreover, we did not detect



compliance with the GCGC be either a market value driver communicating good news to (potential) investors or to be an operating performance driver helping in acquiring cheaper money. High compliance rates do not yet seem to be a competitive advantage for German SMEs. They are obviously not using this potential to differentiate themselves more strongly from other companies by signaling “good” corporate governance. A SME-specific corporate governance code seems to be necessary to improve this situation. In conclusion, we can only report weak support for the agency theory perspective in our data.

In more general terms, the assumptions of institutional theory (e.g., Hooghiemstra et al., 2008) were (surprisingly) found to be well justified by our study. With some exceptions of companies who generally reject the code, code compliance among German SMEs is rather homogeneous. The fact that code compliance did not have a significant impact on either ROE or on SPD highlights that the differentiation potential regarding corporate governance practices (as mirrored by code compliance) was not sufficiently used by SMEs. So, external investors do not see a need for differentiation in this respect.

Notwithstanding the findings our study provides, several *limitations* should be noted. First, our company sample is somewhat limited in regard to size and variety. Furthermore, the data were derived from only one year. Nevertheless, several authors (e.g., Black et al., 2006) have promoted one-year studies, since basic corporate governance practices do not change considerably over time (“sticky corporate governance”). This is supported by previous findings for Germany that only report marginal dynamics in code compliance (e.g., Von Werder et al., 2005, 2006).

Second, declared compliance cannot be considered to be equal to real compliance. In contrast to the US, there is only limited pressure on German companies to proof whether their compliance reporting is correct – testing real compliance is not an integral part of the work of the auditor or of any other supervising institution in Germany. All in all, the risk of managers being punished for false reports must be considered rather low (Theisen and Raßhofer, 2007). Third, Koehn and Ueng (2007) criticize corporate governance ratings based on archival data for not considering internal information from companies within the rating process. Contrary to this, we preferred unsolicited ratings due to their objectivity. Moreover, we also suspected that companies with higher code compliance tend to send back their questionnaire more often than companies with lower compliance, which would result in a considerable non-response bias.

Since this is the first empirical study on code compliance and performance in German SMEs, several aspects remain to be explored in *future research*. One of them is the research of not only the GCGC as a whole, but the examination of the effects of single rules on firm performance and the extent to which they depend on each another (Bassen et al., 2009). Another aspect would be to determine clusters of SMEs with respect to code compliance behavior, which would help to better understand management styles and to give further recommendations for SMEs in structuring corporate governance (Talauciar and Von Werder, 2008). Finally, on the methodological level, going inside the companies and doing case study research on the full range of corporate governance structures could provide some deeper insights into how corporate governance mechanisms are developed and how they function in practice.

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