

Effects of cost and benefit in regularising business procedures in Gauteng: the SMEs paradox - South Africa

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Key Words

SME, New companies Act, business regulations, Dti, CC and Old companies Act Cost and Benefit

Abstract

Gauteng Province is regarded as Economic hub of South Africa due to its industrialisation, Manufacturing and business. Besides it is also known as the capital City of the country and occupies 1.4 % of land space. It contributes 35.6% towards GDP to the country and 10% GDP to the entire African continent. SMEs contribute 42% of employment in the formal economy and 2 million of informal businesses. While close cooperation comprise 78 % of the total registered entities providing more than 20 % annual growth rate. This paper aims to examine the cost and effects of regularising business procedures in Gauteng, South Africa. The objective of the study is to investigate the extent to which regularising business procedures impact on converting SMEs to Pty under the new companies Act. The t-test was used to test the hypothesis and the significance level was $p < 0.00$. The study employed a structured questionnaires and interviews with targeted participants operating as SMEs in Gauteng provinces of South Africa. The sample size comprised of 114 businesses that were randomly selected using five point Likert-scale ranging from One to Five (1) High Extent and (5) No Extent in Gauteng. Chi-square was mainly relied on as a statistical testing. The response rate was 97%. The result indicated that there were more costs than benefits in regularising business. Intensive consultation should have been engaged and awareness be made rigorously with the stakeholders.

Introduction

The cost of governance under the new companies Act and its regulations bring South African company legislation into the 21st century with more emphasis to International Corporate governance in organizations regardless of their size and nature. This was as a result of the 2008 global recession (Hitchcock, 2009). The King III regulates and enforces compliance or opportunity of small companies entering into a world of new rules (King, 2009). Small businesses which were previously not compelled to comply with governance requirement have now to comply with good governance. Subsequently, this promulgated legislative compels small business to formalise and address various government issues such as risk management, annual audit, audit rotation and appointment of secretariat that are stipulated by section 84 and 86 of the Act. In a later stage though now it is not a prerequisite. The cost of regulation and governance on the side of companies to compliance has become a major challenge facing smaller businesses that were not expected to meet the requirement before (Mashamaite, 2011). A study by Djankov La Porta, Lopez-de-Silanes and Shleifer (2007:7), concurs with the above statement that the cost of registering a formal business in South Africa is comparatively high. It amounts to 0.366% of the annual gross domestic product (GDP) per capita. In Canada it is 0.414%, in New Zealand 0.004% and in Chile 0.116%. Other factors also may be blamed on the poor education system that does not encourage people to take up entrepreneurship as a career and the legacy

left by sanctions during the apartheid era. (Maas, 2010:15). While government's intention to educate small business owners remains appreciated, how and when this would be attained remains uncertain.

The merger between companies intellectual property commission (CIPC) and company intellectual property registered office (CIPRO) which stands for office of intellectual property enforcement (OCPE) is now mandated to do administration of educating potential and current SMEs on the functioning of the new companies Act within Gauteng (Meyerman, 2009). The office of compliance (OCPE) is also assigned to advice on the structures of the most relevance for the SMEs business. Among others in their mandatory, OCPE is to provide the necessary conversions from personal liability company to private company as well as public company. According to USAID (2008), only in Gauteng alone there are more than 1,053,818 SMEs owners. Majority of these SMEs in Gauteng are from historically and currently disadvantaged while more than 2 million operate as informal business. This may result in uncertainties on how training on conversions is going to take place and how standards are to be met and ultimately this may results in resistance to new rules although the argument of Meyer man (2009) points out the enforcement which is based on the fact that the act will provide environment of unlimited growth and potential to the SMEs; thus being the rationale behind the implementation of the act (Davis, 2008). Contrary to the assertion made by Davis (2008), it is unlikely that small private companies will meet the prescribed requirements of company's annual financial statement audit (Reitz, 2009).

The above arguments propelled the need to conduct a study with the view to understand what are the challenges of costs and benefits of operating business under the new code of governance. Whereas the companies Act N° 61 of 1973 is no longer relevant in meeting the expectations of businesses anymore. Company law was in desperation of reviewing the Act. The Act did not lay standard on insolvency and Liquidation also there was no inclusion of starting, growing and dissolving of businesses. In actual fact, the small business did not form part of the regulation of the companies Act of 1973. In addition, the Act did not stipulate any measurement regarding directors. In view of this, the king III report on governance and compliance necessitates that the new companies Act is set to provide standard formats for informal rescue discussion with creditors. These procedures seem to be too expensive and costly for SMEs to understand. Also the debate of liquidation and insolvent processes through court orders or special resolution provides an extra burden of SMEs taking into account that most of them are not properly educated to understand these procedures and their implications and this turns in their perception to nullify the benefit of running under the new Act.

Background

The previous companies Act of 1973 laid standard on procedures for running the business through the context of memorandum and articles of associations. The courts had a limited extent permission to dispense the formalities where shareholders were in agreement in unanimous consent such as division to declare dividend whereas the new companies Act in section (74) allows directors to act otherwise. The memorandum of incorporation (MOI) provides any decision voted at board meeting to be adopted or consented as long as it was communicated to all directors by either fax or electronically to fast-track internal formalities. Steenekamp (2009), views the Act to undoubtedly taking many benefits that were prevailing to Close Corporation (CC). The facing out of the CC is regarded as a costly exercise posing challenge to the business environment that has affected the landscape of business for many years. According to the Global Entrepreneurship Monitor (GEM) data, a country at South

Africa's stage of economic development would be expected to have a TEA rate in the order of 15%, over 60% more than South Africa's actual rate of 8.9%. This is accorded to education system as one of the fundamental requirements for a competitive country. South Africa's ranking with respect to primary education is dismal for example according to the 2010/2011 *Global Competitiveness Report (GCR)*, South Africa continues to languish at the bottom end of the scale. The report shows among others that South Africa rank 130 out of 139 countries with regard to quality of education system and on the quality of maths and science it ranks 137 out of 139 countries. This is of particular concern as South Africa currently spends significantly more on education than many other African countries.

The on-going frustrations of poor education system propels one to ask continuous questions, of how will the new companies Act provides solutions in such a complexed environment where education is a must for understanding the legalities and formalities of converting from SMEs to Pty (Rankumise and Chiloane,2012). Wherein, the small business operators still struggles with understanding the formalisation of their business, tax returns and other matters such as capital constraints related to conducting their business (Coolidge, 2010). The extra burden to tax formalities by Fias (2007) provides a further paradox to SMEs taking into account the business compliance regulation clause towards the implementation of the new companies Act thus, making it even worse for small business, taking to account that the Close Corporations (CC) were seen as stepping stone for business vehicle. The phasing out of the CC and requirement set for compliance is perceived as a great obstacle in their business environment (Mashamaite, 2011). It is against this background that the study aims to examine the cost and benefit effects of SMEs under the new companies Act.

Research Design

The study employed the quantitative approach using methodological triangulation. A simple random sample of SMEs in the research population was used, from the Province. 114 structured questionnaires were self-administered and 85 were returned. Gauteng was chosen due to its accessibility and cost implications. Three field workers were employed together with the study leader to collect data. Where the participants were not accessible, telephonic interviews were the source of data collection. The sample comprised of 114 businesses of all gender and races, as well as lawyers who have the understanding of why the Act was passed and the SMEs who are the main stakeholder 85 were returned. Therefore, the study used purposeful sampling where people were chosen for a particular purpose (Leedy and Ormrod, 2001: 219). Participants were "hand-picked" for the research. To assess the effectiveness and efficiency of the Act, data was collected through surveys using a Likert five-point scale questionnaire wherein 1 indicates "High Extent" and 5 indicates "No extent"

Data analysis

Collected data was analysed through SPSS where descriptive and inferential statistics were generated and presented through tables and graphs.

Credibility

Triangulation took place through the multiple data collection techniques such as individual and interviews, field notes were taken to assist to draw conclusions about what constitutes the truth.

Ethical considerations

Permission was sought from the research and ethics committee of the college of economic and management sciences (CEMS) of the University of South Africa for the approval before conducting the study. The research was to adhere to ethical principles as discussed in the declaration of the participants documented by CEMS. Informed consent was used to get permission from the respondents. An explanation was made on (1) the purpose of the study; (2) the study is voluntary; (3) that respondents may withdraw from the study at any given time without prejudice; (4) and that their confidentiality was ensured since no personal identifiers were used.

Benefit of the study

The study provided the researcher in that knowledge gained through the study helped the understanding of the cost and benefit of the Act towards SMEs. It also serves as a guideline to policy implementers about the Act. Furthermore, it highlighted the in-depth of unifying procedures within the South African business environment.

Findings

In order to achieve the research objectives, four hypothetical statements were formulated. Chi-square binominal statistical results were used to test whether a hypothesis was accepted or rejected. It was used to measure the significance level. In a case where the significance level was less than 0.05, the null hypothesis was rejected, while the alternative was accepted. The null hypothesis was rejected since the level of significance was $0.00 < 0.005$. The findings indicated whether the hypothesis was rejected or accepted.

H0₂: Close corporations play important role in small business. The alternative was rejected and the null hypothesis was accepted

H0₃: Merge of CIPRO and CIPC will educate and administer the potential SMEs. The alternative was accepted which means the merging of CIPRO and CIPC was not educative and will not assist or helpful to potential SMEs in converting the SMEs to Pty.

H0₄: Financial standards provide benefits to SMEs. The null hypothesis was rejected because it was less than 0.005 and the alternative accepted.

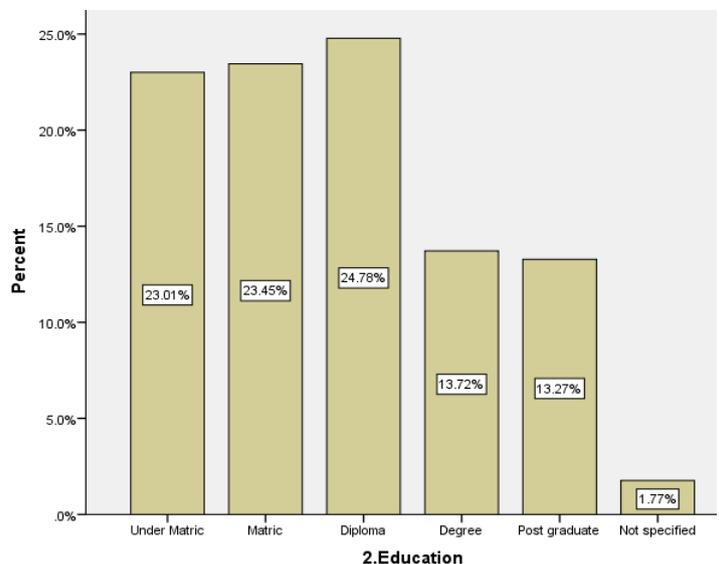
Table 1.1 t.-test Results

Pearson Chi- square test	t	df	Sig. (2-sided)
	85.151	79	.000

Level of significance

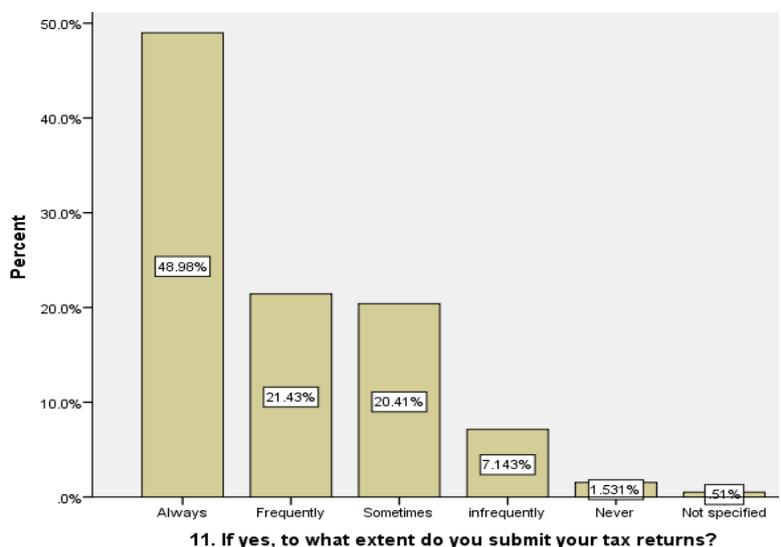
* $p < 0.05$

Fig 1.1 Reports on Education



According to GEM 2010 majority of South African participants who operates small business have a grade 12 or less than matric. The findings on table 3.2, conquers with the report by GEM. It is evident that those who fall under the Matric and Matric levels with 23.01% and 23.05% respectively. This in effect implies that their knowledge to fully interpret the legal content of the New companies Act, and its implications thereof is low compared to those with degrees (13.72%) and diplomas (24.78%) who stand a better chance of comprehending the Act. To therefore eradicate this backlog, emphasis on improving capacity among South African majority on how to operate small business units is imperative. Another issue of concern identified amongst participants is the conversion from CCs to Pty, and the legalities associated with this conversion. Lack of knowledge to pursue the procedure for converting from CC to Pty makes it the more difficult for small business operators.

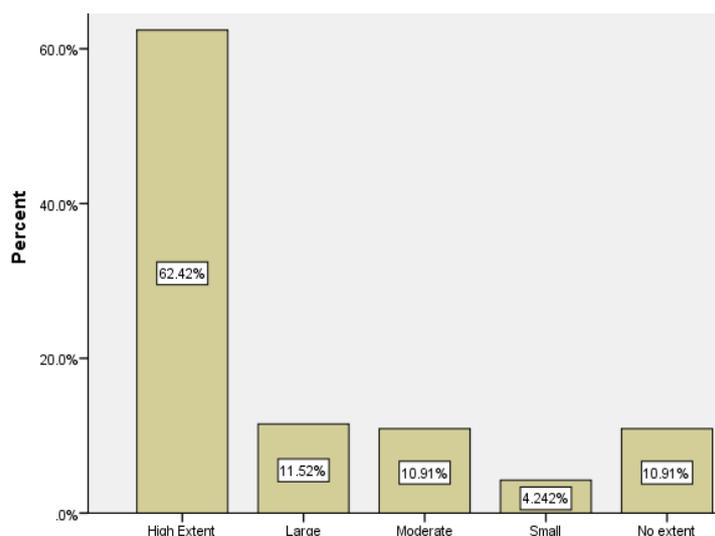
Fig 1.2 Reports on tax submission



The above figure is concerned with the extent to which participants submitted their tax returns. 48% of them affirmed that they always submit their tax returns, compared to 21.43% and 20.41%

who fall within those who 'frequently and sometimes' submit their tax returns. Following the phasing out argument (i.e. from CC to Pty) and adhering to the fact that this process might be detrimental on small business operators, tax returns on Pty which presumably would be more formalized will obviously not yield more comparatively to CCs. This might also affect government revenue. Further, the cross tabulation about tax returns on provinces indicated that Gauteng scored the highest with 32%.

Fig 1.3 Reports on phasing out of the CC



17. To what extent are you affected by the phasing out of CC?

The above table explains that the majority of research participants (62.42%) operating small business were affected by the phasing out of CC. This is because close corporation to them was seen as a panacea to their unemployment misery.

Findings of the statistical analysis revealed that the levels of significance regarding the implementations of the New Companies Act was between $p < .005$ and $p < .05$. Chi-square binominal statistical results were used to test whether a hypothesis was accepted or rejected. It was used to measure the significance level. In a case where the significance level was less than 0.05, the null hypothesis was rejected, while the alternative was accepted. The null hypothesis was rejected since the level of significance was $0.00 < 0.005$.

Report on the Act's benefit to SMEs

76.55% of the participants responded No Extent which indicated that they do not believe that the Act would be beneficial to the sector. While 5.51% of the participants hoped that the Acts would benefit the sector. The latter is in line with Davies (2007) that the Act was to improve the sector. In his argument SMEs would be in a better position in terms of accessing capital or finance in banks which was an obstacle previously due to collateral requirements. 7.56% responded moderately towards the Act benefit. Steenkamp (2009) is of the view that the Act will not benefit the sector instead many small businesses would close due to non-compliance. Chi-square test results indicated $p < .005$ regarding benefit of the Act to SMEs

Report on understanding OCPE and running business under the new Act

70.7% of participants did not understand running business under the new Act while 30% understood the implication of conducting business. The participants who understood running

business under the Act represented those who have degrees, diplomas and matric. 71% did not agree that OCPE will educate the SMEs on converting to Pty and 27% of the participants agreed. The findings indicate that those who were more enlightened perceived the Act positively and believed that there were benefits associated with the Act. These were the participants who understood the code of conduct posed by the King 111 report.

Limitations of the study

The study was limited to Gauteng due to time and financial constraints

Further study

It is recommended that other provinces be surveyed as it will ensure the dynamics of what other provinces are and a common way forward to policy formulas and decision makers.

Recommendations

The following recommendations were suggested:

1. The statistical findings showed that most of the participants did not understand the act and its implications. This study therefore recommends that building capacities within SMEs is necessary for the interest of sustainability and outreach.
2. The study also recommends the crafting of a training module that envisages to temporally educating the operators of small businesses on how to convert from SMEs to Pty.
3. This study recommends mentoring and networks that will inform small business operators through workshops, training seminars in all provinces.
4. A designated budget is vital within local government structures to ensure that information dissemination is attained by the targeted audience, with specific emphasis on rural areas.
5. The study also recommend a coherent monitoring and evaluation service to ensure that there is progress in training SMEs

Managerial Implications

It is clear from the study conducted that government does not have the appropriate skills to negotiate access for business and capacity building as their role. Economists such as Lord Keynes argued in their discourse that government needs to support rather than take the lead role. The managerial implications of SMEs firms, is to recognise that there was a need to participate as equal partners during consultation with government in unifying business procedures. The absence of these major contribute is nevertheless regarded as negative and the implication thereof has taken away the confidence in government. Even though there existed opportunities for better capital offers by financial sectors. Furthermore, the unifying of business regulations has negative implications in that small businesses which were emerging are now faced out due to lack of basic capabilities to cope with the new laws of companies Act compliance. In other words those that were not formalised are automatically out of the game. The argument of Steenkamp propels one to understand that the cost of doing business in the Era is without doubt a challenge in taking away some of the SMEs. The adverse is in essence contributing to additional gap of unemployment.

Lack of participation by business community in unifying procedures can put pressure on government in what is popularised to become a cohessed private -public sector partnership.

Conclusions

While SMEs are regarded as a powerful panacea for poverty eradication and economic growth, it is evident that the potential has been eroded by business regulations that are perceived by the sector to take away their business opportunities. Unless government is going to take appropriate actions to educate SMEs in converting to Pty's many small businesses will close due to lack of compliance. Appropriate structures need to be developed and massive campaign of creating awareness of training centres be in place. Otherwise desired results will be the thing of the past while those who benefitted from CC join the pool of job seekers.

It is in this light that the paper highlighted the bases for countering the debate over business regulation with reference to the cost and benefit of doing business under the new paradigm as well as the fact that the ground is unclear for (1) ensuring that the merger between CIPR and OCIPE will educate SMEs on converging to Pty(2) serve as a facilitator to enhance awareness (3) lower cost of registration and increase efficiency (4) curb red tape in doing business in the country while assisting companies frustration during liquidation. The overall , debate and after objectively capturing the costs and benefits of SMEs under the new Act, in this paper leaves the evidence in the hands of the reader with clear suggestions that SMEs were better off at least for the simple reason that they were providing a platform for unemployment. Although operating in unclear rules rather than under the new business regulation. The pros and cons of it may far out-way the benefit for which the Act was intended for. The King III code of governance and its compliance may ultimately jeopardise the activities of the sector in the long term.

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